

Report To The Mississippi Legislature



A Review of the Implementation of the Venture Capital Act of 1994 and the Operations of the Magnolia Venture Capital Corporation

March 11, 1997

The Legislature passed the Venture Capital Act of 1994 to help develop business climates and improve general economic conditions within the state. Over the venture capital program's two and one-half year history, private and public entities charged with program oversight [Magnolia Venture Capital Corporation (MVCC), Magnolia Capital Corporation (MCC) and the Mississippi Department of Economic and Community Development (DECD)] have not effectively fulfilled their responsibility.

MCC and MVCC have incurred \$4,515,777 in overhead expenditures (one-third of the \$13,791,906 in program funds turned over to MCC and MVCC), which has led to \$2,324,124 in program losses. Including the \$3,672,964 in bond interest the state has paid to date from general funds, the state's actual losses through February 1, 1997, total \$5,997,088. Based on losses incurred to date and future interest costs of the bonds, PEER estimates total costs of the venture capital program to approximate \$26,305,144 from June 1994 through August 2009. MVCC's former Chairman and CEO conducted corporate operations and program activities in a manner which resulted in loss of substantial venture capital financial resources, receiving approximately \$1,980,938 in direct and indirect personal benefits.

Even though the statutory intent of the program was to provide funding for venture capital investments in Mississippi businesses, MVCC has engaged in only one venture capital investment and the program currently does not meet the statutory minimum private capital investment threshold.

The PEER Committee

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**A Review of Implementation of the Venture Capital Act of 1994 and the
Operations of the Magnolia Venture Capital Corporation**

March 11, 1997

**The PEER Committee
Mississippi Legislature**

The Mississippi Legislature

Joint Committee on Performance Evaluation and Expenditure Review

PEER Committee

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March 11, 1997

Honorable Kirk Fordice, Governor
Honorable Ronnie Musgrove, Lieutenant Governor
Honorable Tim Ford, Speaker of the House
Members of the Mississippi State Legislature

At its meeting of March 11, 1997, the PEER Committee authorized release of the report entitled **A Review of Implementation of the Venture Capital Act of 1994 and the Operations of the Magnolia Venture Capital Corporation.**

A handwritten signature in cursive script, reading "Billy Bowles", written over a horizontal line.

Representative Billy Bowles, Chairman

**This report does not recommend increased
funding or additional staff.**

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A Review of Implementation of the Venture Capital Act of 1994 and the Operations of the Magnolia Venture Capital Corporation

March 11, 1997

Executive Summary

Overview

Background of the Venture Capital Program

The Legislature passed the Venture Capital Act of 1994 to help develop business climates and improve general economic conditions within the state. The act vested major responsibility for program operations in a private for-profit corporation (Magnolia Venture Capital Corporation) which was capitalized through a private non-profit parent corporation (Magnolia Capital Corporation). The Legislature approved the funding of this program through the sale of a \$20,000,000 general obligation bond guaranteed by the state.

Actual Costs to Date

MCC and MVCC have incurred \$4,515,777 in overhead expenditures (one-third of the \$13,791,906 in program funds turned over to MCC and MVCC), which has led to \$2,324,124 in program losses. Including the \$3,672,964 in bond interest the state has paid to date from general funds, the state's actual losses through February 1, 1997, total \$5,997,088.

Projected Total Costs over the Life of the Program

Based on losses incurred to date and future interest costs of the bonds, PEER estimates total costs of the venture capital program to approximate \$26,305,144 from June 1994 through August 2009. The cost estimate includes:

- the actual \$2,324,124 loss of capital incurred by MVCC and MCC through January 31, 1997;
- \$14,346,668 in actual bond interest the state will pay from general funds over the fifteen-year term (The total \$34,346,668 to be paid over fifteen years from the general fund for

bond principal and interest includes \$20,000,000 in principal payments which the state will recover when a zero coupon bond required by the Venture Capital Act expires in 2009); and,

- \$9,634,352 in estimated interest the state could have earned by 2009 if it had not paid the \$14,346,668 in actual bond interest over the period.

Summary of Findings

Over the venture capital program's two and one-half year history, private and public entities charged with program oversight have not effectively fulfilled their responsibility. Even though the statutory intent of the program was to provide funding for venture capital investments in Mississippi businesses, the entities have engaged in only one \$650,000 venture capital investment. Yet since the venture capital program's inception, MVCC has incurred large losses resulting primarily from questionable and extravagant procurement of goods and services authorized by the CEO and the board. MVCC's former Chairman and CEO conducted corporate operations and program activities in a manner which resulted in loss of substantial venture capital financial resources. The Chairman/CEO personally benefited from many MVCC expenditures, receiving approximately \$1,980,938 in direct and indirect payments. MVCC investment practices also increased the losses of program resources.

The venture capital program's one investor withdrew most of the money invested in the program, and as a result, the program currently does not comply with statutory requirements for meeting the minimum private capital threshold for the MVC Fund to make investments. Also, MVCC has not met the statutory requirement for seventy percent of its moneys to be invested in "start-up" companies.

MVCC's lax management and board oversight also contributed to weaknesses in its application

review process. Until late 1996, MVCC had not instituted a formal application review process for businesses interested in the venture capital program and had no consistent method of collecting information on such businesses, program components which should have been primary considerations of an equity investment program.

The MVCC board failed to oversee MVCC's business activities by requiring the CEO to disclose detailed financial information on a frequent, regular basis. Magnolia Capital Corporation failed to compel MVCC to produce annual report information which was required by statute to be reported to DECD. Likewise, DECD failed to take timely action to compel MCC and MVCC to comply with the statutory program reporting requirement. Such laxity in oversight led to loss of program resources by permitting the CEO to make procurements and investment actions which did not serve the best interests of the program.

Recommendations

PEER presents recommendations which address the alternatives of:

- continuing venture capital program operations by taking certain corrective measures; or,
- abolishing the program as it currently exists and restructuring the mechanism by which venture capital investment is promoted by the state.

In any event, PEER recommends recovery of funds which appropriate authorities might determine have been misspent by MVCC and prosecution for any determined criminal acts.

Recommendations: If Mississippi Continues the Present Venture Capital Program

PEER identified several aspects of venture capital program operations that need improvement. These include oversight, procurement, investment management, and compliance with state law governing the program.

Oversight

1. The Legislature should amend the Venture Capital Act to require more frequent and more

detailed financial and program activity reporting. The Legislature should amend CODE Section 57-77-21 to require that MCC require MVCC to compile monthly and quarterly financial statements (detailing revenues and expenses) and activity reports and distribute them to the MVCC board of directors, MCC's chairman, the Executive Director of DECD, and the State Auditor. This amendment should require that MVCC pay a penalty if such information is not submitted on a timely basis.

Procurement and Administrative Expenses

2. The MVCC board and officers should make future procurement decisions that are in the best interest of the corporation. Both the MCC and MVCC boards should require MVCC management to use competitive procurement practices for acquisition of goods and services. Engaging in competitive practices could help conserve program resources and make additional funds available for investment.
- MVCC should competitively bid brokerage services on a regular basis, such as yearly, to hold commission and fees to a minimum.
 - MCC and MVCC should not contract with related parties, such as businesses owned by board members or staff or with relatives of board members or staff or businesses owned by relatives. MCC and MVCC should set policies prohibiting conflicts of interest with regard to contracting and other activities. The boards should use the State of Mississippi's conflict of interest statutes, MISS. CODE ANN. Section 25-4-105 and Section 109 of the Mississippi Constitution, as a guide in developing policies.
 - The MCC board should discuss with its legal counsel the retainer agreement and obtain an understanding of the average number of hours spent by counsel on providing services to MCC and the purposes of the services. Based on those discussions, MCC should consider discontinuing the \$5,000 per month retainer agreement and paying for legal services by the hour, or some arrangement which incorporates the most economical form of contractual arrangement. MCC should require that counsel provide an itemized billing for services rendered in order to monitor spending for legal services.

3. The MCC and MVCC boards should develop policies for allowable administrative expenses, especially for salaries and fringe benefits. The boards should request input from the Executive Director of the Department of Economic and Community Development for setting salary levels. The boards should set salary levels based on a survey of venture capital company salaries in southern states and on the venture capital experience of the individuals holding the MVCC positions.

Investment Management

4. In keeping with MVCC's statutory purpose of holding state funds only until such time as venture capital investments in Mississippi businesses can be made:
 - MVCC should discontinue its investments in common and preferred stocks and in corporate bonds which have investment ratings below A as designated by Moody's and Standard and Poor's investment rating services.
 - The MCC board and the MVCC board should obtain an understanding of and regularly discuss the types of marketable securities investments held by MVCC and MVCF and any risks involved in holding those securities.
 - The MVCC board should develop a written plan for temporarily investing funds held until the venture capital investments can be made. The plan should ensure that the funds expected to be used for venture capital in the next one to two years are placed in only the most liquid and conservative investments, such as money market securities. The plan should also prohibit margin loan positions on its investments.
5. In conjunction with any changes to its investment policy, MVCC should adjust its operating revenue and expenditure projections, listed in Appendix D, page 52, to reflect projected reductions in revenue resulting from less risky investments. For example, in the event that MVCC sells its riskier, higher-yielding investments and buys more conservative investments with lower earnings potential, MVCC will realize lower revenues and therefore should reduce its future spending levels in order to continue operations without losses.

Program Compliance With State Law

6. MVCC should cease making investments until the \$4,500,000 private investment requirement is met.
7. The MVCC board should approve future business investment applications using statutory criteria that seventy percent of investments be made in "start-up" businesses to bring its business investment portfolio into compliance with the statutory requirement.

Recommendations: If Mississippi Abolishes the Present Venture Capital Program

If the Legislature chooses to abolish the present venture capital program, the entities involved should take steps to address recouping assets and equity investments, maintaining the program structure until transfer of moneys and duties is accomplished and placement of venture capital duties with state officials is completed. The Legislature should consider various alternative structures when creating a new venture capital program.

Abolition of the Current Program

8. Legislative amendments to abolish the current venture capital program should provide for the systematic liquidation of the subsidiary corporation's (MVCC's) assets and equity investments. The Legislature should require the parent corporation, MCC, to merge MVCC duties and assets under its authority and to continue intact until all assets are transferred to the State Treasurer. Assets of the venture capital program should be deposited into the "State Treasury - Venture Capital Fund" and re-appropriated by the Legislature, should it choose to do so.

Creation of a New Program

9. If the Legislature chooses to create a new venture capital vehicle to channel state resources to private businesses, it should consider several alternatives available for such a program. These alternatives include creating a new venture capital incentive for private organizations to administer the program (such as in North Carolina, which at one time provided state tax credits for investors) or shifting the currently

allocated resources to existing business loan or equity investment programs.

Recommendations for Recovery and Prosecution

10. The Mississippi Ethics Commission should determine whether conflict of interest violations have occurred and pursue recovery of funds in instances where such payments have been made in violation of the ethics laws.

11. The State Auditor should pursue recovery of venture capital program funds where payments have been made on the basis of false invoices or as a result of fraud.

12. The Attorney General should determine whether officers or employees of MVCC committed fraud or other crimes and prosecute those who committed criminal acts.

For More Information or Clarification, Contact:

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A Review of Implementation of the Venture Capital Act of 1994 and the Operations of the Magnolia Venture Capital Corporation

Introduction

Authority

The PEER Committee authorized a review of the Magnolia Venture Capital Corporation (MVCC) and the Venture Capital Act of 1994, pursuant to the authority granted by MISS. CODE ANN. Section 5-3-57, et seq. (1972).

Scope and Purpose

In response to a citizen's request, PEER conducted this review of the operations of the Magnolia Venture Capital Corporation (MVCC), its parent corporation (Magnolia Capital Corporation [MCC]), and the Venture Capital Act of 1994. The purpose of the project was to determine if MVCC has conducted its operations economically and efficiently and to assess whether the program has been administered in accordance with the Venture Capital Act.

Method

In conducting this review, PEER:

- reviewed state law relative to creation and implementation of the Venture Capital Act of 1994 and business corporations;
- reviewed minutes and other records of the Magnolia Venture Capital Corporation and Magnolia Capital Corporation;
- interviewed MVCC's Chairman and Chief Executive Officer and other corporate officers and staff;
- interviewed MCC's Chairman; and,
- obtained information from the following state departments: Treasury, Finance and Administration, and Economic and Community Development.

Overview

Background of the Venture Capital Program

The Legislature passed the Venture Capital Act of 1994 to help develop business climates and improve general economic conditions within the state. The act vested major responsibility for program operations in a private for-profit

corporation (Magnolia Venture Capital Corporation) which was capitalized through a private non-profit parent corporation (Magnolia Capital Corporation). The Legislature approved the funding of this program through the sale of a \$20,000,000 general obligation bond guaranteed by the state.

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Over the venture capital program's two and one-half year history, private and public entities charged with program oversight have not effectively fulfilled their responsibility. Even though the statutory intent of the program was to provide funding for venture capital investments in Mississippi businesses, the entities have engaged in only one \$650,000 venture capital investment. Yet since the venture capital program's inception, MVCC has incurred large losses resulting primarily from questionable and extravagant procurement of goods and services authorized by the CEO and the board. MVCC's former Chairman and CEO conducted corporate operations and program activities in a manner which resulted in loss of substantial venture capital financial resources. The Chairman/CEO personally benefited from many MVCC expenditures, receiving approximately \$1,980,938 in direct and indirect payments. MVCC investment practices also increased the losses of program resources.

The venture capital program's one investor withdrew most of the money invested in the program, and as a result, the program currently does not comply with statutory requirements for meeting the minimum private capital threshold for the MVC Fund to make investments. Also, MVCC has not met the statutory requirement for seventy percent of its moneys to be invested in "start-up" companies.

MVCC's lax management and board oversight also contributed to weaknesses in its application review process. Until late 1996, MVCC had not instituted a formal application review process for businesses interested in the venture capital program and had no consistent method of collecting information on such businesses, program components which should have been primary considerations of an equity investment program.

The MVCC board failed to oversee MVCC's business activities by requiring the CEO to disclose detailed financial information on a frequent, regular basis. Magnolia Capital Corporation failed to compel MVCC to produce annual report information which was required by statute to be reported to DECD. Likewise, DECD failed to take timely action to compel MCC and MVCC to comply with the statutory program reporting requirement. Such laxity in oversight led to loss of program resources by permitting the CEO to make procurements and investment actions which did not serve the best interests of the program.

Background

The Venture Capital Act of 1994

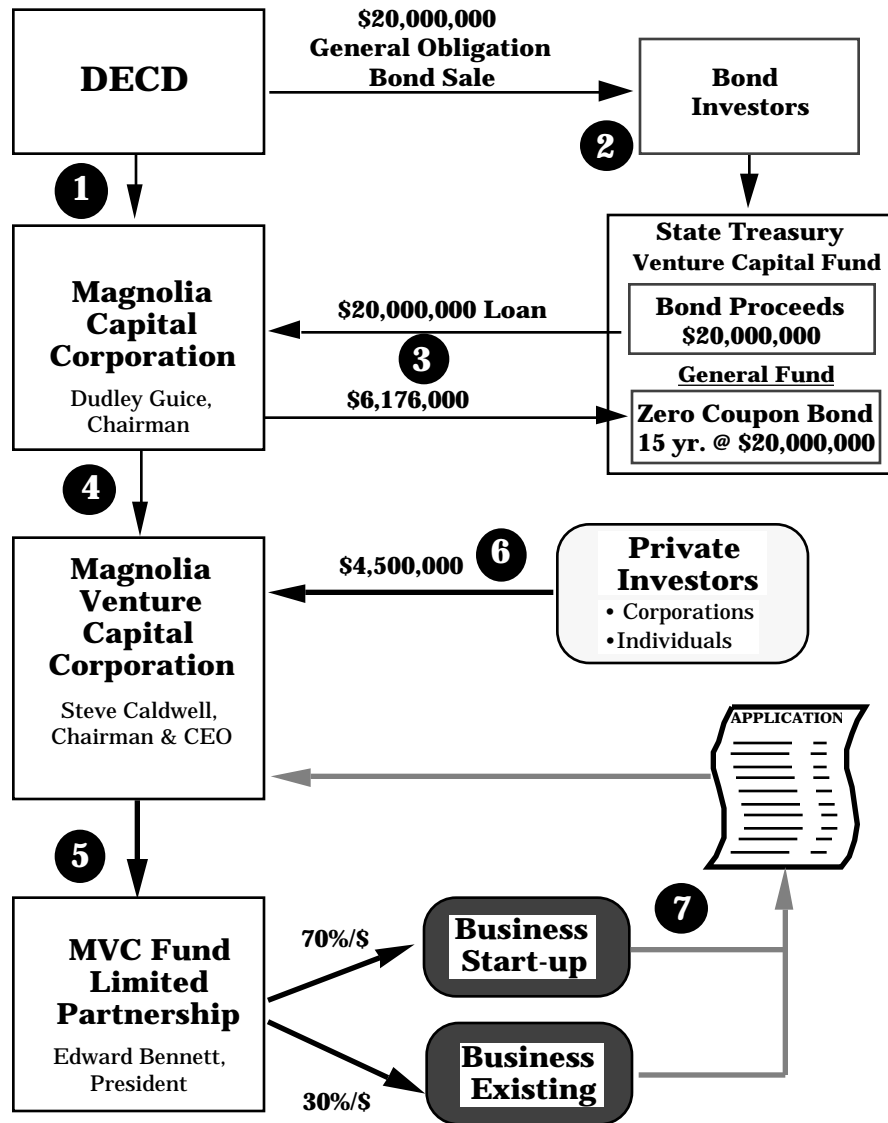
The Legislature approved the Venture Capital Act of 1994 effective April 8, 1994. The act provided for the creation of the Magnolia Capital Corporation (MCC), the Magnolia Venture Capital Corporation (MVCC), and the Magnolia Venture Capital Fund Limited Partnership (MVCF). (See Exhibit 1, page 5, which depicts the relationships between entities involved in venture capital program implementation and operation). According to MISS. CODE ANN. Section 57-77-3, the purpose of the act was to increase the rate of capital formation, stimulate new growth-oriented business formations, create new jobs for Mississippi, develop new technology, enhance tax revenues for the state, and supplement conventional business financing.

A \$20,000,000 general obligation bond, authorized by the Venture Capital Act, served as the vehicle for funding the program. DECD requested that the State Bond Commission issue the general obligation bond. The act provided that the bond principal be repaid to the State Treasury by investing part of the proceeds (up to \$7,500,000) in a zero coupon bond to mature in fifteen years. Favorable interest rates in August 1994 provided for the acquisition of the zero coupon bond at a cost of \$6,176,600. MCC utilized the remaining funds to pay for the bond issuance costs and to capitalize the Magnolia Venture Capital Corporation.

The act gave the Department of Economic and Community Development (DECD) the authority to incorporate MCC and MVCC (see Exhibit 1, page 5). After creation, DECD lent MCC (the non-profit corporation created by the act) the \$20,000,000 proceeds from the bond sale. MCC was required to purchase the zero coupon bond and place it in the State Treasurer's office for safekeeping. MCC used \$13,595,000 to capitalize MVCC (a Mississippi for-profit corporation). According to the act, MCC serves as sole stockholder of MVCC, the entity created to receive and review business applications and provide venture capital funding to spur economic growth.

MVCC was capitalized in August 1994 and subsequently established the Magnolia Venture Capital Fund Limited Partnership. This partnership was intended to let MVCC serve as general partner with a business (who is the limited partner) and establish a mechanism whereby the fund could invest in the business. The role of the partnership was to provide early stage funding for high-growth oriented (expected to experience significant sales growth over five-years) Mississippi businesses. MISS. CODE ANN. Section 57-77-21 specifies that seventy percent of the investment moneys of the partnership are to be invested in start-up business (less than thirty-six months old) while the remaining thirty percent can be invested in existing Mississippi businesses.

Exhibit 1
Relationships of Entities Involved in the Implementation and Operation of the Venture Capital Program



1. DECD creates MCC and MVCC, in accordance with Venture Capital Act.
2. DECD requests \$20,000,000 General Obligation Bond sale and proceeds are deposited into the Venture Capital Fund.
3. DECD lends MCC \$20,000,000 requiring reinvestment of part in a Zero Coupon Bond to repay \$20,000,000 loan in 15 years.
4. MCC uses \$13,823,400 to pay cost of bond offering and purchase, support operations, and capitalize MVCC.
5. MVCC creates the Magnolia Venture Capital Fund Limited Partnership to act as the partner making capital investments in businesses (70% in start-up and 30% in existing businesses).
6. MVCC solicits private investments of \$4,500,000 (the minimum required by the act to operate).
7. Prospective businesses submit applications to MVCC for consideration.

SOURCE: Compiled by PEER.

Prior to MVCC making its first investment in or making a loan to a business, the act required that MVCC secure private investments of at least \$4,500,000 in the MVC Fund Limited Partnership. MVCC entered a contractual agreement with another private venture capital corporation, Capital Strategies Group, Inc. (CSGI), to solicit private investments, screen business applicants, and provide financial advice to MVCC. MVCC and CSGI began soliciting private investments beginning in November 1995 (upon release of the partnership's Private Offering Memorandum) and continued for the next thirteen months (see Exhibit 3, Timeline Of Venture Capital Implementation and Operation, page 8). MVCC accepted a special limited partnership agreement with one investor (Clements Limited Partnership) on December 27, 1995, for \$5,000,000. Because MVCC entered the special agreement with Clements, LLP, and could not offer those terms to three previous investors in the fund, it returned previously received investments totaling \$150,000. The Clements, LLP agreement contained a clause which allowed it to withdraw all but 3 percent of its investment.

Having received the minimum private investment required by the act to provide venture capital to businesses, MVCC officially began the process of reviewing business applications on January 1, 1996.

Disposition of Applications for Venture Capital

For the period January 1, 1996, through January 31, 1997, MVCC received eighty applications from prospective businesses (see Exhibit 2, page 7). Of these, MVCC determined that eighteen were ineligible because they were not Mississippi-based businesses.

Of the remaining sixty-two, one business has retracted its application. MVCC has referred five to another venture capital firm and declined forty-five. MVCC approved one business application (Country Originals, Inc.) and continues to review ten applications.

Exhibit 2

Disposition of Business Plans Received Since Beginning Business (For Period December 27, 1995 to January 31, 1997)

Total Business Plans Received	80
Ineligible (Not Mississippi Businesses)	<u>(18)</u>
Total Eligible Mississippi Business Plans	<u>62</u>

DISPOSITION OF ELIGIBLE PLANS

Inactive

Retracted	1	
Referred To Another Venture Capital Firm	5	
Declined	<u>45</u>	
<u>Total Inactive</u>		51

<u>Active - Under Review</u>	10
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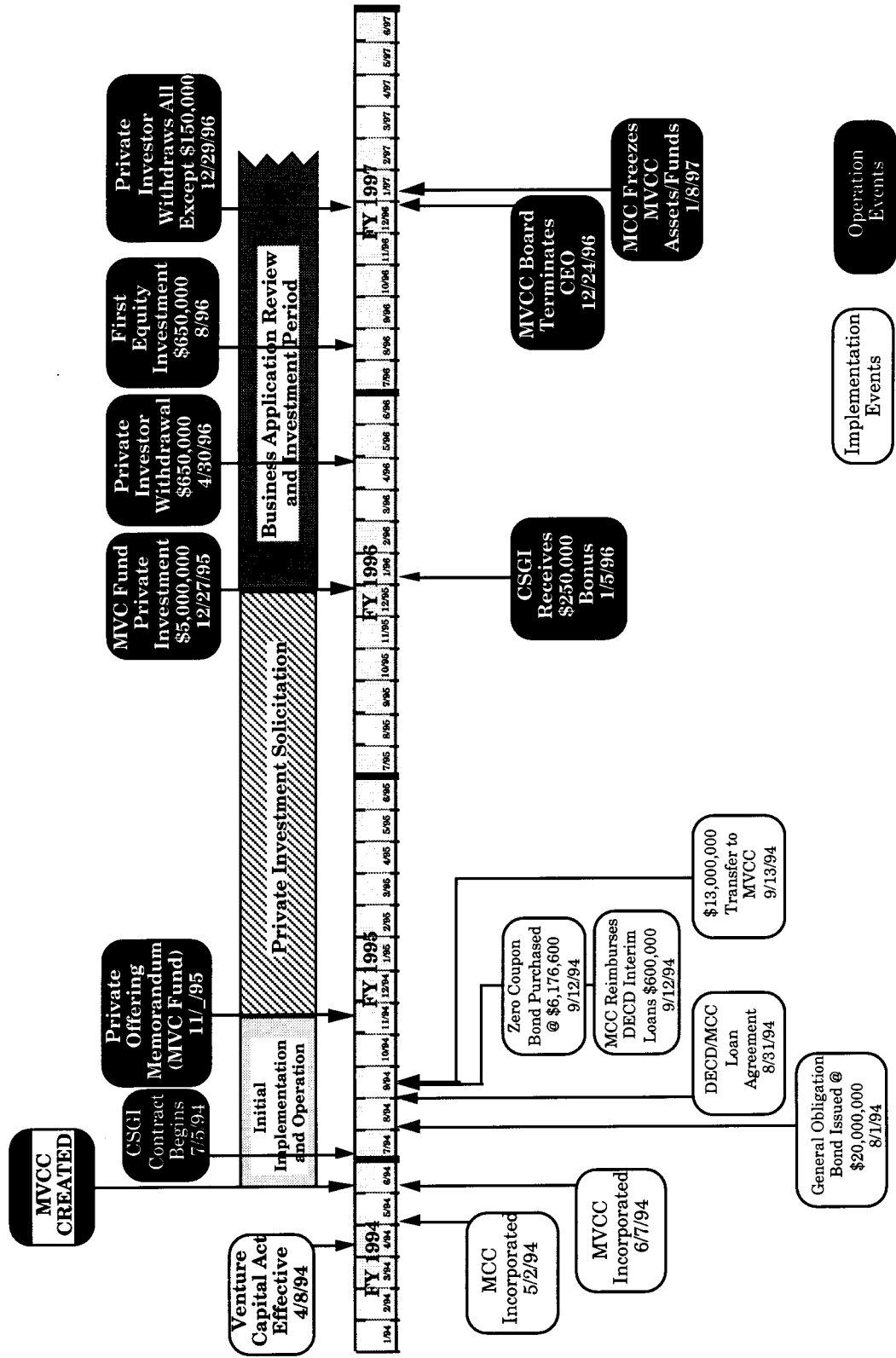
<u>Approved</u>	<u>1</u>
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Total MVCC Actions	<u>62</u>
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SOURCE: MVCC Master Business Plan Log.

Exhibit 3

Timeline Of Venture Capital Implementation and Operation (April 1994 - January 1997)



SOURCE: Compiled by PEER.

Organization Structure of the Venture Capital Program

The Venture Capital Act gave the Department of Economic Development (DECD) director the responsibility for incorporating MCC and MVCC, and making the initial appointments to the board of directors of each corporation. MCC consists of a thirteen-member board. MVCC operations are governed by a five-member board.

MISS. CODE ANN. Section 57-77-9 required the Executive Director of DECD to appoint the original thirteen corporate board members of MCC while Section 57-77-11 required him to appoint the original five corporate board members of MVCC. Exhibit 4, page 10, presents the current board members of each corporation.

MCC does not have any employees and operates only as an oversight body meeting periodically throughout the year. From its membership, the MVCC board elected Steve Caldwell as Chairman on June 6, 1994, and hired him as Chief Executive Officer (CEO) of the corporation on July 5, 1994. The CEO is the administrative head responsible for the day-to-day operations of MVCC. MVCC had six employees during most of the corporation's two and one-half year history. [These positions appear highlighted on Exhibit 4.] One position, a receptionist, is excluded from the chart because it has been vacant since November 1995.

Effective December 24, 1996, the MVCC board terminated the employment of the Chairman and Chief Executive Officer. Since January 1997, MVCC has operated with three full-time employees: two vice presidents and a research director.

Exhibit 4
Organization of the Venture Capital Entities
(As of December 31, 1996)

**Department of
Economic and
Community
Development
(DECD)**

Magnolia Capital Corporation (MCC)
(Parent)

Board (13 Members) [Congressional District#]

Dudley Guice, Chairman [2]

Shin Sidney Lee, Vice Chairman [2]

Christine M. Wardell, Secretary [2]

Shelia M. Williams, Treasurer[4]

Joyce H. Burgess [1]

Gleeton Preston [1]

Samantha Jackson [2]

Carl L. Mickens [3]

Emmett Mickens [3]

Bobby Lamar Cox [4]

Nefela Woods [4]

Lola Baker[5]

Betty Barton[5]

Magnolia Venture Capital Corporation (MVCC)
(Subsidiary)

Board (5 Members)

Almatine
Nichols

Liza Looser
Secretary
Treasurer

Steve Caldwell,
Chairman/
CEO

Jim
Williams

Johnny
Clements

Edward Bennett,
President
(Resigned 3/1/96)

Paul Adcock
Vice President

David Crawford
Vice President
(Investments)

Terri Owens
Research
Director

VACANT
Office
Administrator
(Resigned 5/21/96)

Magnolia Venture Capital Fund Limited Partnership

MVCC
Full-Time
Positions

SOURCE: Compiled by PEER.

Sources and Uses of Venture Capital Program Funds

Under the Venture Capital Act of 1994, the state has used \$5,997,088 in public funds through February 1, 1997. If the state continues to finance the bond issue which established the program through 2009 when the bonds mature, the state will spend an additional \$20,308,056 on actual bond interest payments and foregone interest earnings on the payments. Therefore, projected long-term financing costs and operating losses through 2009 total \$26,305,144.

The \$5,997,088 in state funds used to date include \$3,672,964 in actual bond interest paid and \$2,324,124 used by MCC, MVCC, and MVCF (through net operating losses, decreases in the market value of securities held, and net distributions to the former limited partner of MVCF). MCC and its affiliates (MVCC and MVCF) held \$11,498,769 in assets at January 31, 1997. (See Appendix A, page 49, for a diagram of the flow of funds associated with the implementation and operation of the venture capital program.)

The following sections include details of the original disbursement of the bond proceeds, how the bond proceeds were used, the assets remaining from the bond proceeds, and the total short-term and long-term costs to the state.

MCC, MVCC, and MVCF Received \$13,791,906 of the \$20,000,000 in Venture Capital Act Bond Proceeds

Exhibit 5, page 12, summarizes the disbursement of the \$20,000,000 general obligation bond proceeds. In September 1994, the State Treasurer used \$6,176,600 of the proceeds to purchase zero coupon bonds of behalf of MVCC. MCC and MVCC received \$13,791,906 of the bond proceeds and used \$31,494 of the proceeds to pay the costs of issuance and legal fees.

Appendix B on page 50 outlines the distribution of the funds between MVCC, MCC, and the MVC Fund. Prior to the bond issuance, the Department of Economic and Community Development had made two short-term loans totaling \$600,000 to Magnolia Capital Corporation for initial operating expenses. Subsequently, Magnolia Capital Corporation lent \$595,000 of these funds to its subsidiary, Magnolia Venture Capital Corporation, in June and July 1994. In September 1994, DECD received \$600,000 of the bond proceeds as reimbursement for the short-term loans. Magnolia Venture Capital Corporation received \$13,000,000 of the proceeds, of which \$8,000,000 was later used to capitalize Magnolia Venture Capital Fund. In September 1995, DFA paid the remaining \$191,906 balance directly to Magnolia Capital Corporation, which retained the funds.

Exhibit 5

Disbursement of the \$20,000,000 Bond Proceeds

<u>Description</u>	<u>Amount</u>	<u>Totals</u>
DISBURSEMENTS TO MCC		
Repayment of DECD's 6/2/94 Interim Loan to MCC	\$100,000	
Repayment of DECD's 6/27/94 Interim Loan to MCC	\$500,000	
Bond Proceeds Paid Directly to MVCC	\$13,000,000	
Bond Proceeds Paid Directly to MCC	<u>\$191,906</u>	
TOTAL TO MCC (For Venture Capital Program)		\$13,791,906
BOND ISSUANCE COSTS		\$31,494
COST OF ZERO COUPON BOND (\$20,000,000 in 15 years)		\$6,176,600
TOTAL GENERAL OBLIGATION BOND AMOUNT		<u>\$20,000,000</u>

SOURCE: PEER analysis of MCC, MVCC, Department of Finance and Administration, and DECD records

MCC, MVCC, and MVCF Used a Net \$2,324,124 of Bond Proceeds Through January 1997

As shown in Exhibit 6, page 13, MCC and its affiliates (primarily MVCC) have used a net \$2,324,124 of the \$13,791,906 in bond proceeds since inception of the venture capital program. The \$2,324,124 fund balance consisted of net losses since June 1994 of \$2,147,605, \$107,323 in net distributions to the former limited partner, and \$69,196 in unrealized losses on securities which had decreased in value since their purchase. At January 31, 1997, the assets of the venture capital program had decreased to \$11,498,769, of which \$30,987 were reserved to pay for current liabilities. As shown in the chart, the \$4,515,777 in operating expenses of the entities were the primary factor in the \$2,324,124 loss of bond proceeds.

As shown in the exhibit, the former MVCF limited partner's earnings distributions from the partnership exceeded its original capital invested by \$107,323. Although the limited partner had invested \$5,000,000 in the partnership in December 1995, by November 1996 it had withdrawn all but the \$150,000 required as a permanent investment by the partnership agreement. The remaining limited partnership capital of \$150,000 decreased to \$107,323 after accounting for the \$257,323 in earnings distributions to the limited partner.

(Appendix C on page 51 outlines the period for the limited partnership's withdrawal of funds.)

Exhibit 6			
Use of Bond Proceeds from June 1994 to January 31, 1997			
MCC, MVCC, and MVCF			
Total Bond Proceeds		\$20,000,000	
Less Purchase of Zero Coupon Bond to			
Preserve Bond Principal		(6,176,600)	
Less Bond Issuance Costs		(31,494)	
Net Bond Proceeds to MCC and MVCC			\$13,791,906
Less Fund Balance:			
Revenues (Investment Income)	\$2,368,172		
Expenditures	(4,515,777)		
Total Net Losses Since June 1994		(\$2,147,605)	
Distributions to Former Limited Partner		(107,323)	
Unrealized Losses on Securities		(69,196)	
Fund Balance at January 31, 1997			(\$2,324,124)
Plus Current Liabilities at January 31, 1997			30,987
Total Assets at January 31, 1997			<u><u>\$11,498,769</u></u>
SOURCE: PEER analysis of MVCC, MCC, and Department of Finance and Administration records.			
Numbers in this exhibit have been adjusted for rounding errors.			

***\$2,368,172 in Investment Income Reduced the Impact of the \$4,515,777
in MCC, MVCC, and MVCF Operating Expenses***

As the primary operating entity of the venture capital operations authorized by the act, MVCC has incurred almost all of the administrative expenses for the three entities. MVCC's high level of expenses has resulted in large losses. Exhibit 7, page 14, shows the consolidated revenues and expenses of the three entities, the amount of losses attributable to each of the three entities, and the expenses by type.

Since inception of the program through January 31, 1997, the entities have received \$2,368,172 in revenues related to earnings on investments in marketable securities. Expenses totaled \$4,515,777, resulting in a net loss of only \$2,147,605 when offset against the investment income. The largest expense consisted of \$2,188,139 in salaries and benefits for four to six employees each year (48% of total expenses). The second largest expense was for \$1,087,002 in management fees paid to CSGI, a company owned by the MVCC chairman (24% of the total).

Exhibit 7

Consolidated Revenues, Expenditures and Losses for Fiscal Years 1994 to 1996 and the Seven Months Ended January 31, 1997 Magnolia Capital Corporation and Affiliates

	FY 1994 (1 Month)	FY1995	FY 1996	FY 1997 (7 months)	Total
Revenues *	\$0	\$531,186	\$1,048,745	\$788,241	\$2,368,172
Expenditures	(15,733)	(1,422,888)	(2,309,570)	(767,586)	(4,515,777)
Net Losses **	<u>(\$15,733)</u>	<u>(\$891,702)</u>	<u>(\$1,260,825)</u>	<u>\$20,655</u>	<u>(\$2,147,605)</u>

NOTES:

* Received on Investment Income from Marketable Securities

** Schedule of Net Losses Attributable to Each Entity:

	MCC	MVCC ***	MVCF	TOTAL
Revenues	\$662	\$1,200,933	\$1,166,577	\$2,368,172
Expenditures	(87,523)	(4,378,244)	(50,010)	(4,515,777)
Net Losses	<u>(\$86,861)</u>	<u>(\$3,177,311)</u>	<u>\$1,116,567</u>	<u>(\$2,147,605)</u>

*** Adjusted to remove effect of \$812,329 in earnings distributions received from MVCF.

Consolidated Expenditures by Type

	Amount	% of Total
Salaries and Benefits	\$2,188,139	48%
Management Fees (to CSGI)	1,087,002	24%
General & Administrative	404,821	9%
Legal Fees	360,571	8%
Insurance	146,102	3%
Travel and Entertainment	104,711	2%
Advertising	87,090	2%
Depreciation	53,801	1%
Contract Services	48,545	1%
Dues & subscriptions	34,996	1%
	<u>\$4,515,777</u>	<u>100%</u>

NOTE: Numbers in this chart have been adjusted for rounding errors.

SOURCE: PEER analysis of records of MVCC and MCC.

Total expenditures decreased from an average monthly amount of \$192,000 in FY 1996 to \$64,000 in FY 1997. Factors affecting MVCC's decreased expenditures in FY 1997 included the cancellation of the CSGI contract in November, no recording of depreciation through January, reductions in general expenditures such as travel and entertainment, and reduced salary expenses due

to the departure of the former president of MVCC, Edward Bennett, who had received \$160,000 in severance pay during FY 1996.

*\$11,498,769 in MCC, MVCC, and MVCF Assets Remained at January 31, 1997,
Including Cash and Securities Valued at \$10,331,948*

As shown in Exhibit 8, page 16, the majority of the MCC, MVCC and MVCF assets remaining at January 31, 1997, consisted of cash and securities with a market value of \$10,331,948. Other major assets included \$162,779 of furniture and equipment, \$336,883 in interest income receivable from bond investments and a \$650,000 venture capital investment in Country Originals, Inc.

According to a loan agreement with the Department of Economic and Community Development, Magnolia Capital Corporation owes DECD the \$13,791,906 which it received from the bond proceeds. The debt is shown on the balance sheet as a long-term loan from DECD. Since MCC and its affiliates have claims of \$13,791,906 in long-term debt and \$30,987 in current liabilities against assets of only \$11,498,769, the consolidated fund balance of the entities is a negative \$2,324,124.

Detail of Cash Transactions from June 1994 to January 1997

Appendix C, page 51, details the major cash transactions of MCC, MVCC, and MVCF from June 1994, when MCC received the first \$100,000 loan from DECD, to January 31, 1997. Of the \$13,791,906 in cash received from the bond proceeds by MCC, MVCC and MVCF, only \$10,401,144 in cash and marketable securities remained at January 31, 1997, at cost. The appendix shows that the difference between cost and market value of the securities further reduced the value of the cash and investments by \$69,196 to \$10,331,948.

As shown in the appendix, after the initial receipt of bond proceeds in September 1994, the second major infusion of cash occurred in December 1995. At that time the MVCF limited partner invested \$5,000,000 in the partnership fund, for a total of \$18,791,906 invested from the state and the limited investor. By fiscal year-end June 30, 1996, consolidated cash had decreased to \$15,587,641, primarily due to MVCC's numerous operating expenses and to the limited partner's April 1996 withdrawal of \$675,000 in cash. (MVCC's partnership agreement allowed the withdrawal.) By January 31, 1997, the value of the cash and marketable securities dropped to \$10,331,948, due largely to the limited partner's withdrawal of \$4,175,000 invested in the partnership and to MVCF's first venture capital investment, which cost \$650,000.

Exhibit 8

Financial Position of Magnolia Capital Corporation and Affiliates as of January 31, 1997

	<i>Separate Balance Sheets</i>			<i>Consolidated Balance Sheet</i>
	MCC	MVCC	MVCF	MCC and Affiliates
Cash and Money Market	\$110,045	\$721,613	\$98,800	\$930,458
Investments in Securities at Market Value *		2,076,025	7,325,465	9,401,490
Total Cash and Securities	\$110,045	\$2,797,638	\$7,424,265	\$10,331,948
Accrued Interest Receivable		\$80,748	\$256,135	\$336,883
Furniture & Fixtures		\$52,634		\$52,634
Machinery & Equipment		163,946		163,946
Accumulated Depreciation		(53,801)		(53,801)
Net Fixed Assets		\$162,779		\$162,779
Investment in MVCC	\$13,595,000			-----
Investment in MVCF		\$8,169,573		-----
Venture Capital Investment			\$650,000	\$650,000
Cash Surrender Value of Life Insurance		\$10,294		\$10,294
Security Deposits		\$6,865		\$6,865
Total Assets	\$13,705,045	\$11,227,897	\$8,330,400	\$11,498,769
Current Liabilities		\$30,987		\$30,987
Long-Term Loan (DECD) **	\$13,791,906			\$13,791,906
Fund Balance	(\$86,861)			-----
Stockholder's/Partner's Equity		\$11,196,910	\$8,330,400	-----
Consolidated Fund Balance				(\$2,324,124)
Total Liabilities and Fund Balance	\$13,705,045	\$11,227,897	\$8,330,400	\$11,498,769

NOTES:

* The cost of securities held at 1/31/97 totaled \$9,470,686, resulting in an unrealized loss of \$69,196.

** Amount owed to the Mississippi Department of Economic and Community Development.

SOURCE: PEER compilation of MCC, MVCC, and MVCF financial records and bank statements.

Use of Cash by the Non-Profit Parent Corporation, MCC

As shown in the first column of Appendix C, page 51, MCC had not used large amounts of cash through the fiscal year ended June 30, 1996. MCC's net cash disbursements totaled \$473 in FY 1994, \$3,544 in FY 1995, and \$1,414 in FY 1996. Disbursements during that time consisted primarily of payments to board members for attending board meetings and for related meeting expenses. However, in the seven months ended January 31, 1997, MCC's cash account decreased by \$81,430 (to \$110,045).

The increased expenditures for FY 1997 included a \$60,000 payment on November 13, 1996, to Harry Rosenthal, MCC's attorney, for legal fees. The \$60,000 payment consisted of a \$5,000 per month legal retainer fee paid in a lump sum for the previous twelve month period (November 1995 to October 1996). Other FY 1997 expenses included compensation of \$800 per month to each board member for attending board meetings during November 1996 and January 1997. The MCC board authorized both of these types of expenditures at its November 13, 1996, board meeting. Specifically, the MCC board voted to authorize its chairman to set the compensation level of its legal counsel and raise the compensation for board members from \$200 to \$800 per board meeting.

Estimated Short-Term and Long-Term Costs of the Venture Capital Program Total \$26,305,144

As mentioned above, the principal amount of the \$20,000,000 venture capital bonds will be recovered from investment of the zero coupon bond. However, as the State of Mississippi is responsible for repaying the general obligation bonds through August 1, 2009, the state will incur substantial interest expense costs in financing the bonds over their fifteen-year life.

Through February 1, 1997, the state had paid \$3,672,964 in interest expense on the \$20,000,000 in bonds from the general fund. The state's additional actual bond interest payments through August 1, 2009, will be \$10,673,704, for a total of \$14,346,668 in bond interest payments from the general fund. The state will also incur opportunity costs for not being able to invest the \$14,346,668 in bond interest payments over the fifteen year life of the bonds. Specifically, if the bonds are allowed to mature after fifteen years, the estimated interest earnings which the state could have earned on the \$14,346,668 over the period will total \$9,634,352.

Including the \$2,324,124 in net losses incurred on the venture capital program (which reduced the bond proceeds) and the estimated long-term financing costs (incurred by the state general fund), the total estimated costs of financing the venture capital program are \$26,305,144, as shown in Exhibit 9, page 18.

Exhibit 9

Projected Short-Term and Long-Term Costs of the Venture Capital Program As of February 1, 1997

Losses of State Funds from June 1994 to 2/1/97:

Losses of Venture Capital Program Funds through 1/31/97	\$2,324,124
Actual Bond Interest Paid Through 2/1/97 *	<u>3,672,964</u>

Short-Term Costs **\$5,997,088**

Projected Future Financing Costs:

Actual Bond Interest Payable from 8/1/97 to 8/1/09	\$10,673,704
Estimated Interest Earnings Foregone on the \$14,346,668 in Actual Bond Interest Payments Over 15 years **	<u>9,634,352</u>

Estimated Long-Term Financing Costs **\$20,308,056**

Estimated Long-Term and

Short-Term Costs of the Venture Capital Program **\$26,305,144**

NOTES:

* The state has also paid \$1,675,000 in principal through 2/1/97. The total \$20,000,000 in principal to be paid over 15 years will be recovered when the zero coupon bond matures in 2009.

** Calculated at a 5.5% 1-year Treasury Bill rate.

SOURCE: PEER analysis of MCC, MVCC, and State Treasury information.

These opportunity costs could be offset by any benefit, including future tax revenue, which the state could derive from businesses assisted through the Venture Capital Act.

Findings

Administration of the Venture Capital Act

Neither the MVCC Board, the MCC Board, nor DECD have exercised substantive and periodic oversight over MVCC operations, expenses, or performance, which has resulted in weaknesses in the administration of the Venture Capital Act.

The MVCC board did not monitor operating expenses to make sure that actions taken by the CEO were in the best interest of the corporation. This lack of supervision allowed bad management to go unchecked. Likewise, MVCC's parent corporation, MCC, did not take proper actions to compel MVCC's compliance with reporting requirements in submitting the detailed data needed to evaluate whether the act's purposes were being achieved. DECD must also share responsibility for not exercising periodic oversight and taking measures to compel the production of detailed financial and performance data.

Magnolia Venture Capital Corporation Board Oversight

- ***From MVCC's inception till November 1996, the MVCC board did not exercise substantive periodic (monthly or quarterly) oversight over MVCC by reviewing and approving financial information or performance data.***

Based on a review of MVCC's minutes and other information, the board did not review monthly or quarterly reports of revenues and expenses or periodic performance data relevant to MVCC operations. The board did not require the Chairman/CEO to produce these reports and make them available to the board. Had it done so, the board might have averted excessive expenditures of MVCC resources. As a result of further requests of the board, the CEO finally provided the board with financial information. Its concern over several of the noted expenses led to further inquiries of board members concerning MVCC transactions and ultimately to the board's decision to terminate the employment of the CEO.

MVCC's CEO (Caldwell) did not make financial information available to the board on a regular basis, and did not present financial detail in his reports to the board. During his two and one-half year tenure as Chairman/CEO, he presented the board only summary balance sheets, containing no expenditure detail. The Chairman/CEO provided the balance sheets at only two of the twenty-two board meetings over two and one-half years.

At MVCC's October 27, 1994, board meeting, the CEO presented balance sheet information from its KMPG Peat Marwick audit report for the period ended September 30, 1994. This financial information summarized the financial condition following MVCC receipt of the \$13 million in capitalization funds in September 1994. This report showed no detailed information because MVCC had experienced no significant operational revenues and expenditures prior to the end of the reporting period.

Two years lapsed before the Chairman/CEO presented the board with FY 1996 basic financial information. At its meeting on October 3, 1996, the Chairman/CEO provided the board MVCC's FY 1996 financial statements without the accompanying footnotes. The CEO withheld the footnotes from his presentation to the board because he had returned them to the audit firm for correction. These footnotes noted several questionable financial transactions that occurred during FY 1996 and involved payments to related parties.

The members of the board had a right and responsibility to review the corporation's detailed financial information. The MVCC board had a right to review financial information under the Mississippi Business Corporation Act, Section 79-4-8.01, subsection (b), which sets forth the duties of the board:

All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors, subject to any limitation set forth in the articles of incorporation or in an agreement authorized under Section 79-4-7.32.

It was not until the board's special meeting on October 29, 1996, that the CEO presented the board with the financial statement footnotes, which were highly critical of MVCC financial transactions. In a subsequent management letter to board members, MVCC's audit firm (Poole, Cunningham and Reitano, P.A.) raised several concerns about MVCC's financial stability and adherence to the requirements of the Venture Capital Act of 1994. These concerns primarily centered upon liberal expenditure actions of the board and the CEO during periods of financial loss which occurred during fiscal years 1995 and 1996. In addition, the audit firm noted such actions as:

- large bonuses paid to employees during these fiscal years
 - payments to two corporations (CSGI and American Telesys) which are owned by MVCC's CEO
 - lack of documentation of services provided under a consulting contract with CSGI
 - large expenditures for travel and entertainment
 - payments for CSGI office space and office services expenses
 - payments of stock transaction commissions to CSGI in addition to monthly contractual payments
- *MVCC's former Chairman/CEO benefited either directly or indirectly from many of MVCC's expenditures.*

Several questionable expenditures resulted due to the board's lack of oversight (i. e., exercising its authority for expenditure review and approval) and lack of MVCC practices to establish expenditure need and document expenses. A

large portion of the expenditures benefited Steve Caldwell, the Chairman/CEO of MVCC, either directly or indirectly.

The Chairman/CEO of MVCC benefited both directly (through his employment as an officer and employee of MVCC) and indirectly by payments made to contractual firms in which he was owner. Caldwell received direct benefits of \$746,888 and indirect benefits of \$1,234,050, for a total of \$1,980,938. Exhibit 10, below, provides breakdown of these benefits, which are discussed in the following section.

Exhibit 10		
Direct and Indirect Benefits Received By Steve Caldwell		
(For Period July 1994 through December 1996)		
	<u>Amounts</u>	<u>Totals</u>
DIRECT BENEFITS (From MVCC)		
Salaries	\$512,500	
Bonuses	150,000	
Board Meeting Per Diem	4,250	
Automobile Allowances	19,200	
Scottsdale Arizona Trip Expenses (Reported As Income)	2,024	
MVC Fund Distributions	44,303	
Personal Membership in Capital Club	4,274	
Life, Health, and Dental Insurance	10,337	
Total Direct Benefits		\$746,888
INDIRECT BENEFITS		
Management Fees & Expenses Paid to CSGI	\$855,527	
Commission on Private Investment Collected by CSGI	250,000	
Stock and Bond Transaction Commissions Paid to CSGI	50,000 *	
Floor Space Provided At No Cost to CSGI	5,367	
Equipment and Services Purchased From American Telesys, Inc.	73,156	
Total Indirect Benefits		\$1,234,050
TOTAL DIRECT AND INDIRECT BENEFITS		\$1,980,938
* Stock and bond transaction commissions received through CSGI are conservatively estimated. The actual amount may approach \$56,000.		
SOURCE: MVCC Financial Records.		

- *MVCC entered related party contracts totaling \$1,045,147, resulting in potential conflicts of interest. The contracts contributed to a lack of oversight because they did not specify deliverables and did not require detailed documentation of the services provided as a condition of payment.*

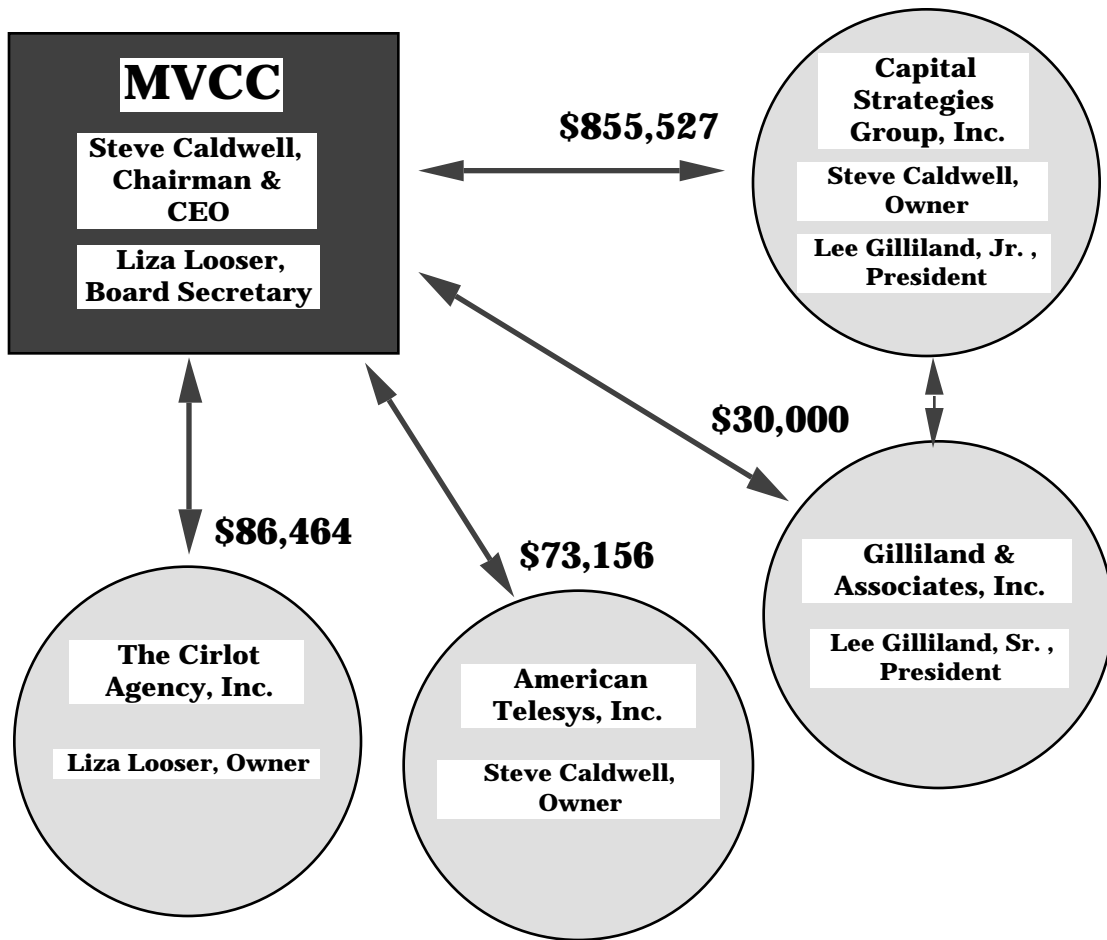
At its first meeting, the board granted the Chairman the authority by resolution to obtain retainer proposals and execute retainer agreements with attorneys, accountants, financial advisors, and other professionals. Although the Chairman was given this authority, he did not make procurement decisions based on competitive practices so that the best interest of the corporation (conserving its resources) would have been served. According to board minutes and MVCC files, MVCC did not seek competitive proposals from firms involved in securities marketing, investment management, or venture capital investment.

As a result, MVCC entered contracts or procured products and services from related party vendors in which the Chairman/CEO and a board member had an interest (see Exhibit 11, page 23). The board contracted for the above-mentioned services with CSGI, a corporation owned by MVCC's Chairman/CEO. MVCC did not solicit competitive quotations or proposals on its telephone equipment, services, and maintenance which it procured from American Telesys, Inc. (another corporation owned by MVCC's Chairman/CEO). MVCC also procured advertising services (without competitive proposals) from Cirlot, Inc., a company owned by the board's Secretary Treasurer. The CSGI and Cirlot contracts were entered into with approval of the MVCC Board of Directors. The CEO submitted the proposals to the board and the interested party abstained from voting. The board considered no other proposals for these services and the contracts were approved unanimously. Although the products or services may have been purchased at competitive prices, these transactions give the appearance of impropriety in MVCC's contractual arrangements and equipment purchases. Even though MVCC is not required to adhere to state purchasing guidelines, good business practices require that businesses obtain the lowest price for comparable services.

MVCC procured broker and promotional services from Patrick L. Gilliland and Associates, which is indirectly associated with MVCC's Chairman/CEO. This corporation is owned by Patrick Lee Gilliland, Sr., father of the president of CSGI, Lee Gilliland, Jr. Steve Caldwell, MVCC's Chairman and CEO, is owner of CSGI.

The questionable contractual arrangements noted have resulted primarily because MVCC did not follow competitive procurement practices throughout its existence. The board and the CEO did not establish the need for and require competitive proposals, bidding, negotiations, or quotations prior to entering contractual agreements or procuring major corporate assets. Related party contracts are obvious examples of such non-competitive procurements. Both the MVCC board and CEO are responsible for procurements from related parties.

Exhibit 11
Financial Transactions Between Board Officers
and Related Party Contractors and Vendors



Total Related Contracts = \$1,045,147

SOURCE: Compiled by PEER.

Under the Mississippi Business Corporation Act (Section 79-4-8.42), an officer or director of a corporation has a responsibility to conduct business in the best interest and to the benefit of the corporation. The above-described procurement actions were not taken in the best interest of the corporation. If MVCC had chosen to conserve program resources through using competitive practices, more funds could have been available for the program's primary purpose (i.e., investing venture capital in Mississippi businesses).

-- *MVCC did not require documentation of consulting services provided under the consulting contract with Capital Strategies Group, Inc.*

MVCC entered a contract with CSGI for “consulting services” at its second board meeting on July 5, 1994. MVCC’s contract with CSGI listed three services to be provided:

1. *to act as sales agent to raise money for Mockingbird partnership [an earlier name for the MVC Fund, LLP];*
2. *to screen any and all applicants for money from MVCC, including financial and background checks and any other specific needs as identified by President of MVCC;*
3. *to act as financial advisor with regard to insurance, pension, or investment of MVCC funds in short term instruments.*

CSGI invoices over the period have not contained sufficient detail to document the activities or services provided to MVCC. Instead CSGI presented a monthly billing to MVCC stating the services rendered as: “Monthly Retainer \$25,000.”

On the invoices presented to MVCC for payment, CSGI did not provide a detailed explanation of services rendered. The absence of documentation of services rendered gives the appearance that few or none were provided, and moneys paid to CSGI were wasted.

The MVCC Board should have stipulated in the contract that CSGI provide sufficient detail on a monthly basis to determine basic performance information such as the number of private investor contacts made, number of applicants screened, background checks conducted and type of financial advice provided. Such information documenting CSGI activities would have aided MVCC in producing annual report information required by statute to be reported by MCC to DECD. This information would have helped enable the MVCC Board of Directors to exercise proper oversight of the CSGI contract.

-- *CSGI did not pay interest to MVCC on four monthly collections (July - October, 1996) of \$3,500 from MVCC for business services expenses which were later repaid.*

On June 1 1996, CSGI made a written request to MVCC for an “additional administrative assistant” at a cost of \$3,500 per month. The extra expense was approved on the authority of MVCC’s CEO on the same day. CSGI billed charges for these “office expenses” or “secretarial expenses” (as they were stated on CSGI’s monthly billing) at \$3,500 for the four subsequent months (July - October). On October 28, 1996, CSGI’s president notified MVCC that he had not hired an employee to provide the business services and was canceling the agreement and returning the money. CSGI stated that it returned the \$14,000 received over the previous four months because of “less investment activity than anticipated and inability to secure appropriate personnel.” CSGI did not compensate MVCC for any interest that would have been earned on this amount over the four-month period.

The MVCC board subsequently terminated the CSGI contract because of questions arising from the MVCC-CSGI relationship. The board had concerns about these charges and CSGI's receipt of a \$250,000 commission on the \$5,000,000 private investment of Clements LLP.

-- *MVCC paid \$5,367 for additional floor space for CSGI without justification.*

The CSGI contract provided that MVCC "shall provide one (1) fully equipped office for the use by Capital." From July 1994 to April 1996, MVCC provided CSGI one office within MVCC's suite of offices at Suite 410, on the fourth floor of the Heritage Building, 400 East Capital Street in Jackson, Mississippi. This space was reserved for use by CSGI's one employee, Lee Gilliland, Jr. The space within the MVCC office was intended as CSGI's secondary location because the MVCC-CSGI consulting contract stipulated that CSGI "shall at all times maintain and provide a separate place of business at its own expense that will be its primary location within the Jackson metropolitan area."

In April 1996, MVCC rented an additional 800 square feet office space for CSGI (a suite of four offices) on the third floor of the Heritage Building at a monthly rental cost of \$766.67. Over seven months this amounted to \$5,367. No justification for the rental of this space is documented in the records of MVCC. CSGI operations did not necessitate additional floor space in close proximity to MVCC offices because the offices never housed more than one employee.

-- *MVCC provided data processing, telephone and computer equipment, office furnishings, and other support to CSGI.*

MVCC supported CSGI operations by bearing the costs for automated accounting and office equipment and furnishings. CSGI's consulting contract stipulated that MVCC would be responsible for providing "one (1) fully equipped office" for use by CSGI, but required CSGI to "maintain a separate place of business at its own expense." MVCC satisfied the contract by providing an office to the CSGI President until May 1996. When CSGI moved to a separate office suite in May 1996, MVCC provided telephone and computer equipment and office furnishings to CSGI at no cost.

The MVCC contract with CSGI provided that MVCC would be responsible for providing an office and reimbursement of expenses. The contract stipulated that MVCC would reimburse CSGI expenses on submission of an itemized account of expenditure. Throughout the contractual relationship, CSGI submitted its monthly billings claiming expenses such as travel. CSGI's itemized expense reimbursement requests never included telephone or computer support costs. The cost of the services were borne by MVCC and not billed back to CSGI.

From January 1, 1996, CSGI automated accounting records were maintained on MVCC data processing equipment. Accounting software purchased and installed by MVCC on its computer system was used to process and report CSGI accounting activity on a periodic basis.

When CSGI moved to a new location (the Heritage building third floor office suite) in May 1996, telephone and computer equipment was installed and linked by communications cables to MVCC's systems on the fourth floor. Costs of such installation and operation of the equipment were paid for through MVCC accounts. MVCC also purchased and placed office furnishings in CSGI's third floor office suite. CSGI used this equipment and furniture until it closed its office in November 1996, when the MVCC board terminated the contract. During the course of the review and after the CSGI contract was terminated and CSGI moved out, PEER inspected the CSGI suite and found office equipment and furniture of sufficient quantity to equip the office fully.

MVCC's provision of such telephone and data processing services and office furnishings exceeded contract requirements when CSGI obtained separate office space. The MVCC-CSGI consulting contract stipulated that CSGI "shall at all times maintain and provide a separate place of business at its own expense that will be its primary location within the Jackson metropolitan area." MVCC should have required that CSGI pay the costs of installation and maintenance of such equipment and furnishings.

-- *MVCC did not conduct a detailed review of the proposed CSGI contract by checking venture capital investment qualifications and backgrounds of CSGI personnel.*

The MVCC board approved CSGI contract at the second meeting of the MVCC board. The minutes contain no documentation to show that the board sought or reviewed other proposals for "consulting services" prior to selecting CSGI. PEER found no documentation in MVCC's files of services desired under the contract or an evaluation of the qualifications of personnel to be delivering those services. The files contained no background checks conducted on the principals of the CSGI organization (i.e., Steve Caldwell and Lee Gilliland, Jr.)

It is incumbent upon businesses to select contractors that are the most well suited and qualified to perform a particular job at the least cost. In order to justify the selection of CSGI, MVCC should have documented the firm's qualifications and experience to deliver the services proposed in the contract. Because it did not, MVCC had no assurance that the services would be provided by the most qualified firm.

- *The MVCC Board approved employment contracts for the CEO and Fund President which allowed a liberal amount of automobile and club membership expenses. These costs exceeded \$36,000 for the life of the contracts.*

At its second meeting, the MVCC board approved the employment contracts of MVCC's CEO, Steve Caldwell, and the Fund President, Edward I. H. "Ted" Bennett. These contracts included amounts for a business car expense monthly allowance of \$600 in addition to the reasonable itemized expenses of the operation of such car. Authorized expenses included amounts for taxes, insurance, tags, fuel and maintenance. An examination of monthly payroll and expense records confirmed that the CEO and the President had consistently been paid both the \$600 allowance in addition to automotive expenses claimed throughout their employment. These car allowances amounted to \$32,100 paid in addition to regular car expenses.

The employment contracts also required MVCC to pay expenses for club membership and affiliations, pension and disability coverage, and all other reasonable expenses. During Steve Caldwell's employment, MVCC paid club membership expenses of \$4,274 and insurance costs of \$10,337.

- *The MVCC Board and CEO awarded \$294,000 in salary bonuses to employees during periods of financial loss.*

Over calendar years 1995 and 1996 MVCC board members and the CEO awarded a total of \$294,000 (30 percent of salaries of \$982,146) in compensation bonuses, (see Exhibit 12, below). The board approved awarding bonuses to the CEO and Fund President of \$225,000 over the two calendar years. These bonuses were awarded in addition to salary increases of \$75,000 and \$12,500 awarded to the CEO and Fund President, respectively, over their tenure. The CEO also awarded \$69,000 to the MVCC vice presidents during this period.

During the time frame when the bonuses were awarded, financial statements showed net losses for MVCC of \$888,159 in Fiscal Year 1995 and \$1,445,493 in Fiscal Year 1996.

Exhibit 12**Bonuses Awarded To MVCC Employees
(For Calendar Years 1995 and 1996)**

	CY 1995			CY 1996		
	<u>Salary</u>	<u>Bonus</u>	<u>% of Salary</u>	<u>Salary</u>	<u>Bonus</u>	<u>% of Salary</u>
Steve Caldwell, Chief Executive Officer	\$182,500	\$75,000	41.1%	\$255,000	\$75,000	29.4%
Edward "Ted" Bennett, President	\$146,875	\$75,000	51.1%	\$43,750	\$0	0.0%
Paul Adcock, Vice President	\$92,160	\$9,000	9.8%	\$110,605	\$30,000	27.1%
David Crawford, Vice President	\$18,756	\$0	0.0%	\$132,500	\$30,000	22.6%
TOTAL	\$440,291	\$159,000	36.1%	\$541,855	\$135,000	24.9%
TOTAL FOR CY 1995-1996				\$982,146	\$294,000	29.9%

SOURCE: MVCC payroll records.

-- *MVCC incurred more than \$33,000 in questionable travel and entertainment expenses for a staff planning meeting during FY 1996.*

Upon the authority of MVCC's CEO, all six MVCC employees and spouses and two contractual representatives (Lee Gilliland, Jr., president of CSGI, and Paul Johnson, contractual legal counsel) and spouses attended a "planning meeting" in Scottsdale, Arizona, in Fiscal Year 1996. MVCC paid for the airfare and accommodations and meals of spouses during this trip. Total costs for the trip exceeding \$33,000. Although board members have a responsibility to participate in the decision making process concerning organizational planning, no members of the board of directors attended this planning meeting.

The MVCC employees attending the meeting included the CEO, President, two vice presidents, the research assistant and the secretary. Costs for the MVCC employees and spouses totaled \$19,619, including \$7,414 in costs for spouses. MVCC paid the airfare for all sixteen people at a cost of \$8,340. In addition, MVCC paid expenses of \$5,296 for Gilliland and Johnson. According to current MVCC management, no formal planning document was produced from this meeting.

Magnolia Capital Corporation Oversight

- ***MCC did not exercise the full extent of its authority to obtain information on MVCC operations and administration of the Venture Capital Act .***

The Magnolia Capital Corporation (MCC), parent corporation of MVCC, is responsible under the Venture Capital Act for annually reporting to the Department of Economic and Community Development (DECD) financial and program activity. MISS. CODE ANN. Section 57-77-21 requires that:

Magnolia Capital Corporation shall submit the following reports to the department [DECD]:

- (a) An annual audit of loan funds received in connection with the program*
- (b) An annual report each year describing all venture capital assistance provided to businesses by Magnolia Venture Capital Corporation and the fund, such reports to include at least the following:*
 - a description of the business receiving assistance, the project to be assisted and the purpose of such assistance;*
 - a description of each loan and equity investment, including the terms and conditions thereof and the use of the venture fund's assistance by the business;*
 - history of the assistance pool, including amounts expended for administration and management, principal amount of equity investments, losses, loans and other relevant data. [Emphasis added]*

Although MCC attempted to secure this information after the completion of each of two fiscal periods (FY 95 and FY 96) as detailed in the following paragraphs, MVCC failed to submit timely and complete reports.

MVCC did not report statutorily required information to MCC or DECD for the fiscal year ended June 30, 1995. After a request from MCC, MVCC's consultant contractor, Capital Strategies Group, Inc., informed MCC on November 3, 1995, that "Due to circumstances at the accounting firm which are beyond our control the financials will not be available before Friday, November 10, 1995."

The MCC board addressed MVCC's delay in providing the report at its November 8, 1995, annual meeting. MVCC did not send the information as promised and on November 13, 1995, MCC formally requested the information from its subsidiary MVCC. The correspondence files of MCC, MVCC, and DECD contain no documentation that MVCC provided any "annual report" information which addressed item (b) as stated above.

The issue of compliance with the reporting requirements was not formally raised again until MCC's November 1996 annual meeting at which the board discussed MCC's October 24, 1996 request for reports. On October 24, 1996, MCC again requested annual report information required by statute. Again, MVCC provided only a cursory response by supplying a balance sheet which did not

provide detail of MVCC income and expenses or the disposition of any business applications (annual report information required under item (b) of Section 57-77-21).

MVCC's reasons for not providing the annual report were that no loans had been issued during the reporting period, and there was no activity upon which to report. However, the subsection requires that the annual report address the "history of the assistance pool, including any amounts expended for administration and management." MVCC has the responsibility to provide detailed financial information on its administrative and management costs so that MCC could in turn report it to DECD.

Other than letters of request to MVCC for information, MCC did not take stronger measures to oversee the operations of its subsidiary. MCC could have availed itself of Mississippi statutory measures governing business corporations to compel MVCC to provide information. The Mississippi Business Corporation Act provides the parent corporation recourse to obtain financial information on a subsidiary. Since MCC is the sole shareholder, MISS. CODE ANN. Section 79-4-16.20 requires that a corporation provide to its shareholders its annual financial statements (including a balance sheet, income statement, a statement of changes in shareholders' equity, and a public accountant's report, if one exists), within 120 days after the close of the fiscal period. The Mississippi Business Corporation Act provides for inspection of corporate records by shareholders:

A shareholder of a corporation is entitled to inspect and copy. . .any of the following records of the corporation:

- 1. Excerpts from minutes of any meeting of the board. . . ;*
- 2. Accounting records of the corporation; and*
- 3. The record of shareholders.*

Exercising its authority under this statute, MCC could have engaged a private audit firm to conduct an independent audit of MVCC's operations. The shareholder could have requested the court to compel the production of corporate records for examination. As parent corporation (100% stockholder) of its MVCC subsidiary, MCC has the authority to "merge the subsidiary into itself without approval of the shareholders of the parent or subsidiary." MCC could have issued a threat to merge MVCC operations into MCC as a means of urging the production of financial expenditure detail and annual report information.

*Department of Economic and Community
Development's Oversight*

- ***DECD exercised no ongoing oversight of Venture Capital Act operations and permitted non-compliance with statutory reporting requirements even though this was a material default in a covenant of its loan agreement.***

State law established legislative intent that DECD play an active role in program implementation and oversight of MCC and MVCC operations. PEER examined DECD's actions in implementing and monitoring the program and assessed whether DECD has exercised proper oversight over MCC and MVCC program operations to insure that the Venture Capital Act was properly administered.

MISS. CODE ANN. Section 57-77-9 and 57-77-11 set forth DECD's responsibility for implementation of the act by forming the corporations and appointing their initial membership. The DECD incorporators played an integral role in coordinating the capitalization of the entities in September 1994 and appointment of both MCC and MVCC boards, attending initial meetings and advising each board. DECD executed this program implementation responsibility in accordance with the statute.

MISS. CODE ANN. §57-77-19 requires that DECD "assist the Magnolia Capital Corporation with such corporation's compliance with the program provided for in this chapter," i.e., the Venture Capital Act. This section required DECD to assist MCC with its oversight of the program set up in the act, yet there is no documentation of DECD providing assistance to MCC.

Section 57-77-25 (1) further establishes DECD's responsibilities for oversight in the development of venture capital program operations, stating that DECD shall adopt and publish:

- eligibility criteria for MCC to participate in the program;
- a timetable and process of review of applications from MCC; and,
- program report forms.

DECD only partially addressed the items required by this section. The most closely related DECD action to adopt and publish MCC criteria to participate in the program is the DECD - MCC Loan agreement finalized prior to transfer of funds to MCC. This agreement set forth requirements as stipulated in the law that MCC invest part of the proceeds to repay the \$20,000,000 loan, and that MCC submit an annual audit of loan funds and an annual report of all venture capital assistance provided to businesses. DECD did not formally adopt and publish a timetable and process of review of applications from MCC and program report forms.

By specifying the reporting criteria in its loan agreement, DECD acknowledged its ongoing oversight responsibility. The responsibilities included assessing whether the program was operating as it was legislatively intended to

operate by providing investments in businesses based on criteria set forth in the statute, e.g., whether the business is Mississippi-based, whether it is "high growth" oriented, and whether it is a start-up or existing business.

DECD restated its oversight responsibility following the initial organizational meetings of MCC and MVCC. DECD responded to an MCC inquiry concerning clarification of its responsibilities under the act on September 2, 1994, setting forth the requirements for the annual report information to be provided to MCC by MVCC. Beyond restating the annual reporting requirement, DECD allowed MCC's non-compliance and did not take additional measures to secure the information.

-- *Although DECD was aware of MCC's and MVCC's failure to report critical information, DECD did not formally request the information until after PEER began this review.*

DECD was aware of reporting problems because DECD representatives attended MCC meetings when MVCC's failure to report critical information was discussed. A DECD representative was present at MCC's November 2, 1995, board meeting where the board addressed MVCC's delay in reporting necessary information. The DECD representative (Deb Collier) who was present at this meeting said when informed of the reporting delay that "she was speaking on behalf of the department, and was sure that a delay would be acceptable." Following this meeting, there is no documentation that DECD representatives monitored or oversaw MCC or MVCC operations and assessed the program's performance.

Because DECD did not force MCC and MVCC to comply with the reporting requirement, the department could not assess whether MCC's administration of the act was in compliance with state law. The information was not provided for two successive fiscal years; therefore, DECD did not exercise its oversight responsibility during that time. DECD did not issue requests for the MCC information until November 11, 1996, after PEER began its review.

-- *DECD did not demand information from MCC even though this failure to report constituted default on MCC's \$20,000,000 loan agreement with DECD.*

DECD's tolerance of reporting problem brings into question whether MCC has defaulted on its loan agreement with DECD. The DECD Loan Agreement with MCC, upon which the transfer of the \$20,000,000 investment was predicated, contains a covenant (item 5.1) which specifically requires MCC to provide to DECD an annual audit and an annual report as specified in MISS. CODE ANN. Section 57-77-21. The events of default under the loan agreement specify in subsection (b) of Section 6.1 that "failure by MCC to observe and perform in any material way any covenant" shall result in default. Based on PEER's examination of this agreement, MCC's non-compliance with reporting requirements established conditions for default of the agreement and gave DECD the opportunity to apply leverage for submission of the report.

Magnolia Venture Capital Corporation's Compliance with Statutory Requirements

Venture capital program operations could be jeopardized by MVCC's non-compliance with requirements of the Venture Capital Act. The act required that MVCC obtain \$4,500,000 in private investments prior to making any business investments and distribute seventy percent of its investments to Mississippi start-up companies (less than three years old). Both requirements are currently not being met.

Magnolia Venture Capital Corporation began transacting business without first meeting the private capitalization requirements of MISS. CODE ANN. Section 57-77-11.

The Venture Capital Act of 1994 prohibited the Magnolia Venture Capital Corporation from beginning business until it had raised four and a half million dollars in private investments. MISS. CODE ANN. §57-77-11 provides in part:

(6) No business may be transacted or indebtedness incurred . . . until consideration of Four Million Five Hundred Thousand Dollars (\$4,500,000.00) has been paid to Magnolia Venture Capital Corporation or to the fund.

Deb Collier of the DECD staff drafted the venture capital bill. The Legislature made only one significant change to the bill when it added the \$4.5 million private capitalization requirement. By adding this requirement, the Legislature required that a portion of the funds available for venture capital investments be derived from private investors. In turn, the private investor would benefit, receiving a state tax credit on the funds invested.

MVCC's officers solicited private investors as limited partners to meet this requirement. On December 27, 1995, a limited partner (Clements, LLP) made a conditional contribution of five million dollars to the Magnolia Venture Capital Fund. That day, MVCC and the limited partner executed a Limited Partnership Agreement which permitted the limited partner to withdraw up to 97% of the partnership interest originally purchased. Only 3% of the capital (\$150,000) was unconditionally paid in as legal consideration into the Magnolia Venture Capital Fund. This conditional contribution was nominal consideration only and did not meet the legal requirement of "consideration" set by MISS. CODE ANN. Section 57-77-11. However, MVCC immediately began operations.

During April 1996, the limited partner withdrew \$4,850,000 (97% of the original contribution). This was the maximum withdrawal permitted by the Limited Partnership Agreement, and left only \$150,000 invested in the MVC Fund. There were no other contributors to the fund. After the limited partner's withdrawal of funds, only state funds were available to pay for losses incurred by MVCC.

To date, MVCC has not met statutory requirements to invest seventy percent of the moneys in “start-up” businesses.

State statute and board resolution required that a large portion of venture capital funds go to start-up businesses. Section 57-77-11, subsection (5) requires that “seventy percent of these investment moneys acquired by the fund for which the tax credit is allowed and available must be invested to provide venture capital financing of start-up businesses.” The MVCC Board echoed this at its first meeting with a resolution mirroring this requirement.

However, MVCC’s first investment, in August 1996, was for acquisition of equity in a company (Country Originals, Inc.) which had existed for over three years. As such, the business could not have met the “start-up” criteria specified in Section 57-77-11. The statute does not require that this criteria be met annually; however, it is incumbent on MVCC to insure that this requirement is met over the life of the program.

Magnolia Venture Capital Corporation’s Investment Practices

MVCC management failed to maintain a conservative investment strategy for bond proceeds held for venture capital investments in Mississippi businesses.

When MVCC received the \$13,000,000 in bond proceeds in September 1994, the company initially placed the funds in conservative investments, including money market mutual funds, municipal bonds highly rated for safety, and U. S. government agency securities. However, in May 1995, MVCC began converting the funds into preferred stocks, a riskier form of investment. MVCC continued to increase its investments in corporate bonds and preferred stocks over time in order to generate higher returns to be used for operating expenses. Then in August 1996, CSGI, Caldwell’s investment company, began purchasing common stocks, an even riskier form of investment, on behalf of MVCF.

As shown in Exhibit 13 below, by December 1996, MVCC and MVCF had invested 2.5% of partnership and corporation funds in common stocks, 42.2% in preferred stocks, 35.9% in corporate bonds and only 19.4% in more conservative cash, money market and U. S. government securities. Although the entities owned \$12,555,053 in securities at December 1996, the investments were worth only \$10,362,501 net of \$2,192,552 in margin loans made against the investments. During January 1997, after termination of its chairman on December 24, MVCC management sold its government securities and portions of its stocks and bonds in order to repay its margin loans. At the end of January, the entities’ securities were valued at \$10,331,948. Because MVCC sold its government securities during the month, only nine percent of the remaining portfolio consisted of conservative investments.

Exhibit 13

**Cash and Marketable Securities Assets by Type
As of December 31, 1996, and January 31, 1997
MCC, MVCC, and MVCF**

	<u>12/31/96</u>	<u>% of Total</u>	<u>1/31/97</u>	<u>% of Total</u>
Cash and Money Market	\$700,264		\$930,458	
U.S. Government Securities	<u>1,739,455</u>			
Subtotal	\$2,439,719	19.4%	\$930,458	9.0%
Corporate Bonds	4,506,508	35.9%	4,474,290	43.3%
Preferred Stocks	5,295,951	42.2%	4,896,325	47.4%
Common Stocks	<u>312,875</u>	<u>2.5%</u>	<u>30,875</u>	<u>0.3%</u>
Total Cash and Securities *	\$12,555,053	100.0%	\$10,331,948	100.0%
Less margin loans at 12/31/96	(2,192,552)			
Value Net of Margin Loans	<u><u>\$10,362,501</u></u>		<u><u>\$10,331,948</u></u>	

NOTE: * January investments decreased due to payout of a \$2,192,552 margin loan during the month. Securities are shown at market value.

SOURCE: PEER analysis of MVCC and MVCF records

MVCC personnel stated that they did not develop a written plan for investing funds available to be used for venture capital. According to an MVCC Vice President, MVCC planned to invest its funds in securities with the best yield available which would also allow MVCC to liquidate without loss when the funds were needed for venture capital investments. MVCC would place those funds which were to be invested in venture capital in the near future into more liquid investments with a lower income yield. For the higher yielding investments, MVCC and CSGI chose to invest in both corporate bonds and preferred stocks with staggered maturities. As MVCC needed the funds for venture capital, MVCC planned to own a variety of securities from which to choose to sell at a gain or at break-even.

- ***State law provides guidelines for investment of public funds.***

While the investment strategy described above appears valid from a private investor standpoint, MVCC did not appear to factor into its informal strategy the duty to invest funds in a way which would protect the public interest. Although MVCC was operated as a private corporation, until the funds could be invested in venture capital in Mississippi businesses under the requirements of MISS. CODE

ANN. Section 57-77-11 (5), MVCC should have protected the funds from excessive risk.

Although the venture capital originating legislation does not address how the funds should be invested prior to venture capital investments, funds held for a statutory purpose should be invested with similar due care as used for other public funds. For instance, the Mississippi CODE outlines ways in which public funds should be prudently invested. According to MISS. CODE ANN. Section 27-105-33, funds held in the state Treasury must be held in deposits with financial institutions, certificates of deposit and U. S. government-backed securities, and, as a result, are held to a very high standard of investment safekeeping. The statutes allow less conservative investment strategies for certain state funds which are meant to be held over the long-term, including funds held in trust to generate earnings for educational improvement and funds held in the state retirement system, as outlined below.

MISS. CODE ANN. Section 7-9-103 requires that the Education Improvement Trust Fund balances be invested only in the following types of investments:

- general obligations of the state of Mississippi and its political subdivisions and certain other state-related securities,
- certain municipal bonds issued in the U. S.,
- deposits in federally insured institutions in the state,
- U. S. - backed securities or funds collateralized by federal agency securities,
- corporate bonds rated A or better,
- certificates of deposit and repurchase agreements, and
- Tennessee Valley Authority bonds.

MISS. CODE ANN. Section 25-11-121 requires that funds of the Public Employees' Retirement System (PERS) be invested in similar type investments as for the Educational Improvement Trust Fund, except that PERS may invest 50% of its portfolio in common and preferred stocks, 5% of its total investments in corporate and taxable municipal bonds in securities rated Baa, 20% of its portfolio in certain foreign securities, and 5% of its portfolio in certain other securities and also may invest in covered call and put options.

- ***Large percentages of MVCC and MVCF investments do not meet statutory guidelines for prudent investing of public funds.***

PEER compared MVCC's investments to the investment requirements for public funds outlined in the MISSISSIPPI CODE and found that MVCC has not adhered to general statutory guidelines for prudent investing of public funds.

Because MCC had invested its \$110,045 in a bank account and because MVCC invests the funds for MVCF, this section refers to MVCC as the party responsible for investment policies. As shown in Exhibit 12 above, MVCC and its related entities had invested 48% of the portfolio in common and preferred stocks as of January 31, 1997.

Although the law allows PERS to invest in common and preferred stocks, PERS investments are to be held for much longer periods of time than are the funds held by MVCC (until the retirement of state public employees). Therefore, fluctuations in the values of securities will be much less likely to result in losses for PERS than for MVCC. As a result, it may not be prudent for MVCC to use PERS's strategy when its mission should be to hold the funds conservatively until such time as the Venture Capital Act can be fulfilled.

Nevertheless, PEER found that of the \$4,474,290 in corporate bond investments at January 31, 1997, 93% would not meet the statutory requirements for investing PERS funds. The statutes do not allow PERS to invest in corporate bonds which have an investment rating below Baa. In fact, Moody's Investors Service, a national bond rating company, has defined Ba-rated bonds as having "speculative elements" with debt payments "not well safeguarded." Moody's definitions state that bonds rated B "lack characteristics of the desirable investment." However, at January 31, 1997, MVCC and MVCF had invested \$4,181,486 in lower-rated Ba and B bonds.

Exhibit 14 on page 38 shows MVCC's investments at January 31, 1997, by type of security as compared to statutory requirements for funds held in the State Treasury, the Education Improvement Trust Fund, and PERS. The Exhibit shows that 89% of MVCC securities of all types would not meet statutory requirements of the Education Improvement Trust Fund and 40% would not meet the requirements for investment of PERS funds.

MVCC management exhibited a lack of fiduciary responsibility by investing in securities which would not sufficiently safeguard funds provided by the state to be used for statutory purposes. The Legislature enacted the Venture Capital Act to provide public funds for venture capital, which is one of the highest forms of investment risk. However, the Legislature specified that the funds be offered only to Mississippi companies. Therefore, until such Mississippi investments could be made, MVCC should have invested the funds conservatively.

Exhibit 14

Comparison of the Marketable Securities of MCC, MVCC, and MVCF to the Statutory Investment Criteria for Various State Public Funds As of January 31, 1997

Categories of MCC, MVCC and MVCF Marketable Securities	Amount of Securities at January 31, 1997	<i>Investments Which Do Not Meet Statutory Requirements of the Following Public Funds:</i>		
		State Treasury	Education Improvement Trust Fund	Public Employees Retirement System
Cash and Money Market	\$930,458			
Corporate Bonds				
Rated A or better	194,188	194,188		
Rated Baa	98,616	98,616	98,616	
Rated Ba or B	4,181,486	4,181,486	4,181,486	4,181,486
Preferred Stocks	4,896,325	4,896,325	4,896,325	
Common Stocks	30,875	30,875	30,875	
Total	\$10,331,948	\$9,401,490	\$9,207,302	\$4,181,486

Percent of MVCC and MVCF Securities Which Do Not Meet Statutory Investment Requirements for Certain Public Funds	91%	89%	40%
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SOURCE: PEER analysis of Magnolia Venture Capital Corporation and Magnolia Venture Capital Fund records and Mississippi statutes.

Investing in riskier securities than normal for public funds results in a risk of loss of public funds. Decreases in securities values would require that MVCC either sell at a loss or maintain the investment until the stock or bond price regain its original value. For instance, the partnership did incur a substantial loss of \$61,255 when it sold Payless Cashway corporate bonds in September 1996. MVCC had originally purchased these bonds, which are rated B3 and B- by the investment rating companies, in January 1996. MVCF also incurred a \$47,449 loss on sale of TCI Communications preferred stock in January 1997. The partnership recorded a net seven-month securities loss of \$21,907 as of January 31 due to gains recorded from sales of other securities.

Because the MVCF and MVCC portfolios contain an additional \$4.2 million in securities rated Ba and B as of January 31, 1997, the entities could continue to see similar losses. If MVCF had sold its remaining shares of Payless Cashway bonds and TCI Communications preferred stock at January 31, 1997, it would have realized additional losses of \$66,131.

CSGI earned commissions exceeding \$50,000 on investment of MVCC and MVCF securities. This caused a conflict of interest between the goals of safeguarding state funds and generating earnings for the MVCC chairman's company.

In June 1996, MVCC had invested the non-cash funds under its control with three brokerage services, American General Securities, Prudential Securities and Everen Securities. At the end of June and during July 1996, MVCC transferred these funds to The Capital Strategies Group, Inc., the investment consulting firm owned by the MVCC chairman, Steve Caldwell. At that time, Capital Strategies became the investment broker for the majority of MVCC and MVCF funds and Steve Caldwell began earning the commissions for trading these securities.

During the six-month period ending December 31, 1996, Capital Strategies completed twenty-six purchase transactions and twelve sales transactions on behalf of MVCC and MVCF. During this period, Capital Strategies earned approximately \$56,000 in brokerage commissions for trading MVCC and MVCF securities, according to board minutes and records obtained from MVCC. (In addition, CSGI received \$38,731 in consulting fees from Gilliland & Associates in February and March 1996. MVCC officials have stated that the \$38,731 in income represented 50% of the commissions which Pat Gilliland, Sr., the MVCC investment broker, earned for investing MVCC and MVCF funds during a two-month period.)

The opportunity for Steve Caldwell, through his 100%-owned company, to earn commissions for trading securities of MVCC and MVCF resulted in a strong conflict of interest. The incentive to earn fees for trading securities conflicted with the fiduciary duty of Mr. Caldwell to prudently invest the funds provided through a public source. For instance, when CSGI assumed management of MVCC and MVCF securities, the company further increased the risk of loss in the portfolio by investing in one of the most risky forms of investment, common stocks. By December 31, 1996, CSGI had purchased common stock investments in six different companies valued at \$312,875. As shown in Appendix D, page 52, sixty-five percent of these common stocks in the amount of \$202,375 were assigned a "below average safety" rating by Value Line Investment Services, a national investment rating service.

In order to reduce risk in the portfolio subsequent to the termination of the chairman of the board, MVCC sold five of the six stocks in January 1997 for a total gain of \$39,461.

MVCF limited partner withdrawals of funds in fall 1996 resulted in \$2.5 million in margin loans when management did not sell investments to cover the withdrawals.

As stated on page 33, the limited partner in the MVCF Fund first withdrew a portion (\$675,000) of its original \$5,000,000 in capital in April 1996. In October and November 1996, the MVCF limited partner withdrew another \$4,175,000 in funds from the partnership. Because MVCC, the general partner of MVCF, had

invested the partnership funds in long-term investments and the fund did not have enough liquid investments to cover the withdrawals of funds, a deficit in the fund resulted. The deficit was covered by margin loans from the brokerage services, with interest rates ranging from 8.25% to 10%. As a result of the margin loans, the fund paid \$24,258 in interest expense for the seven months ended January 31, 1997.

In January 1997, the MVCC board and staff liquidated several investments in order to pay off the margin loans. MVCC also consolidated the MVCC and MVCF brokerage funds into the Prudential Securities brokerage account and withdrew all funds from Steve Caldwell's CSGI brokerage account.

Magnolia Venture Capital Corporation's Application Review Process

Throughout MVCC's existence, it has received applications from businesses. This includes the period prior to December 27, 1995, when it had not reached the \$4,500,000 private investment threshold and could not make investments. Both before and after it reached the threshold, MVCC acted upon the information submitted by businesses. MVCC had not defined an application review process nor a standardized method of review; thus, MVCC's actions were inconsistent.

MVCC's venture capital application review process has not ensured that its staff reviewed and evaluated applications in a consistent manner based on uniform criteria.

MVCC files of business applicants contain information from businesses which have sent information or submitted business plans for review. (PEER uses the term "applications" to include letters of inquiry, basic financial information, and formal business plans.)

MVCC began receiving information from businesses as early as 1994. Although MVCC was not in a position to invest in businesses until January 1, 1996 (when it reached the minimum of \$4,500,000 private investments), the corporation began evaluating the information submitted and corresponding with companies. Companies made contact with MVCC primarily because MVCC and CSGI representatives were publicly promoting the sale of private investments in the MVC Fund.

- ***MVCC's lack of a formal application review process or restrictions on its contractor's interaction with inquiring businesses allowed CSGI to promote its own services to MVCC contacts.***

MVCC's application review process was not formalized for most of its existence. The CEO established no formal procedures or steps to be used as a guide in evaluating the businesses that applied for venture capital.

The lack of a defined process for handling applications meant that both MVCC employees and CSGI personnel initially received inquiries and applications. Applications have flowed freely between MVCC and CSGI since inception of the program. Prior to achieving the \$4,500,000 threshold, MVCC referred about fifty-eight percent of the applications received to CSGI (see Exhibit 15, page 42), usually because MVCC staff either determined the business had no merit or it was not in a position to invest. MVCC referred a small portion of the applications to CSGI for "screening" under its contractual agreement. Likewise, CSGI referred some applications to MVCC.

MVCC's private placement memorandum (the document describing MVCC operations to prospective investors) stated that CSGI would serve as a referral source for businesses seeking venture capital; however, CSGI's contract did not require this. Many of the contractual services CSGI provided were not documented. However, a few files contain background check documentation which CSGI initiated. After MVCC achieved its \$4,500,000 private investment threshold at the end of 1995, it began to refer fewer applications to CSGI (refer to Exhibit 15, page 42) for review or background checks. However, CSGI referred a large portion of the applications to MVCC.

Since MVCC had not set up a standard method of application intake, either CSGI or MVCC could receive applications. MVCC's contract with CSGI did not require immediate submission of all applications received or restrict CSGI activity with businesses. Because CSGI had no contractual restrictions on its interaction with businesses, CSGI often offered the businesses its own services, which may have included formulation of business plans or seeking capital from other financial sources for a commission. MVCC's contract with CSGI established no restrictions on CSGI's soliciting of business from companies it came into contact with during the course of its promotion of the venture capital program. In early 1996, MVCC personnel initiated a master business plan log for tracking applications received, but this did not preclude receipt of applications. This left the opportunity for CSGI to promote its own venture capital services and develop contracts with prospective companies. Several files reviewed contained documentation that CSGI promoted its own services with prospective companies, either independently or upon referral from MVCC.

In addition to performing "screening" services under its consulting contract, MVCC has referred companies to CSGI. According to correspondence contained in the files, CSGI offered services to applying companies that included serving as:

. . .an investment banker capable, on a fee basis, of finding alternative means of financing and/or assisting companies

throughout the southeast which, for whatever reason, have been rejected by the Magnolia Venture Capital Fund.

CSGI has also approached businesses outside the MVCC application review process and offered venture capital funding assistance. CSGI's offer of services to MVCC's venture capital clients ceased with the termination of the contractual arrangement in November 1996.

Exhibit 15				
Comparison of Application Referrals				
Prior To and After MVCC Reaches \$4,500,000 Threshold				
(For Period July 1, 1994 to January 31, 1997)				
Period (In 6 Month Intervals)	Disposition			TOTAL
	Referred To CSGI	Referred From CSGI	No Referral	
<u>Before MVC Fund Reached \$4,500,000</u>				
7/1/94 - 12/31/94	2	3	3	8
1/1/95 - 6/30/95	17	9	1	27
7/1/95 - 12/31/95	24	6	9	39
TOTAL (Inception To Threshold)	43	18	13	74
Percent of Group Total	58.1%	24.3%	17.6%	100.0%
<u>After MVC Fund Reached \$4,500,000</u>				
1/1/96 - 6/30/96	3	24	8	35
7/1/96 - 1/7/96	3	7	34	44
TOTAL (Threshold To Present)	6	31	42	79
Percent of Group Total	7.6%	39.2%	53.2%	100.0%
TOTAL APPLICATIONS				
	49	49	55	153
Percent of Total	32.0%	32.0%	35.9%	100.0%
NOTE: Fourteen business files did not contain sufficient information to determine disposition.				
SOURCE: Compiled by PEER.				

- ***MVCC's application review process allows resources to be wasted because it does not ensure that an applying business meets basic qualification criteria prior to initiating other review procedures.***

Throughout most of its existence, MVCC had no standardized forms for gathering basic information on businesses which would aid in determining whether the business qualified for investment capital. This resulted in collection of the basic qualifying information in an incidental and haphazard way. The Venture Capital Act requires that investments be based on whether the business is a Mississippi business, whether it is a startup (less than three years old) or existing company, and whether the business is "high growth." The act defines a high-growth business as one expected to experience significant sales growth over the subsequent five-year period. Traditionally, MVCC did not consistently collect such information until it had begun its "due diligence" review on a business. The absence of the basic information weakened the initial review process because it devoted resources to reviewing business plans and other operating data prior to ensuring that a business met the basic criteria.

Since PEER began this review, MVCC staff have designed standardized forms which collect basic qualifying criteria in addition to other essential intake information.

MVCC's Use of Resources in Making Business Investments

MVCC has expended a substantial portion of its resources toward administrative overhead, while acquiring minimal investments or loans in private business ventures. If the trend experienced over the past two and one-half years continues, MVCC administrative overhead expenses will exhaust the \$13 million in "seed funds" before MVCC has the opportunity to invest in businesses.

MVCC's expenditure of resources for overhead costs far exceed its venture capital investments made in state businesses.

MVCC's goal was to invest in twenty businesses over five years (four businesses each year). One year has passed since MVCC reached the investment level required by statute to invest in businesses and MVCC has made one investment. During August 1996, MVCC invested \$650,000 in Country Originals, Inc., a Jackson-based business. This investment represents 4.8% of the initial \$13,595,000 venture capital program funds turned over to MVCC. At the same time, administrative overhead expenses during the two fiscal years leading up to this investment have amounted to \$4,515,777 (33% of the initial funds).

According to current MVCC staff, they have conducted favorable "due diligence" reviews on other business applications, but investments in these companies are still pending. MVCC's vice presidents stated that previous efforts to gain approval for additional limited partnership investments were met by opposition of MVCC's former CEO.

MVCC's Recent Venture Capital Program Cost Reductions

The MVCC Board has recently implemented cost cutting measures and developed a five-year budget to sustain MVCC's operations with no further loss of assets. The cost-cutting measures include maximizing MVCC revenue and reducing expenses.

Following the CEO's termination, remaining MVCC staff developed projections of operating costs based on reduced expenses in several areas, (see Appendix E, MVCC and MVC Fund Financial Projection, page 53). To arrive at projected income and expenses, MVCC staff made several assumptions:

- current rates of return on MVCC's investment portfolio;
- reductions in expenses; and,
- a conservative level of business investment over the next three and one-half years.

The revenue and expense projections for the next five fiscal years show a net profit each year. Investment revenues sustain MVCC operations based on current financial holdings. Revenue for the five-year period would be derived primarily from earnings on investments of the MVC Fund and MVCC's portfolio with small amounts available from sale of excess furniture and equipment. The projections include estimates for seven additional business investments of \$360,000 each over the next three and one-half years.

The revised budget was approved by the MVCC Board of Directors at its January 6, 1997 meeting.

Recommendations

PEER presents recommendations which address the alternatives of:

- continuing venture capital program operations by taking certain corrective measures; or,
- abolishing the program as it currently exists and restructuring the mechanism by which venture capital investment is promoted by the state.

In any event, PEER recommends recovery of funds which appropriate authorities might determine have been misspent by MVCC and prosecution for any determined criminal acts.

Recommendations: If Mississippi Continues the Present Venture Capital Program

PEER identified several aspects of venture capital program operations that need improvement. These include oversight, procurement, investment management, and compliance with state law governing the program.

Oversight

1. The Legislature should amend the Venture Capital Act to require more frequent and more detailed financial and program activity reporting. The Legislature should amend CODE Section 57-77-21 to require that MCC require MVCC to compile monthly and quarterly financial statements (detailing revenues and expenses) and activity reports and distribute them to the MVCC board of directors, MCC's chairman, the Executive Director of DECD, and the State Auditor. This amendment should require that MVCC pay a penalty if such information is not submitted on a timely basis.

Procurement and Administrative Expenses

2. The MVCC board and officers should make future procurement decisions that are in the best interest of the corporation. Both the MCC and MVCC boards should require MVCC management to use competitive procurement practices for acquisition of goods and services. Engaging in competitive practices could help conserve program resources and make additional funds available for investment.
 - MVCC should competitively bid brokerage services on a regular basis, such as yearly, to hold commission and fees to a minimum.
 - MCC and MVCC should not contract with related parties, such as businesses owned by board members or staff or with relatives of board

members or staff or businesses owned by relatives. MCC and MVCC should set policies prohibiting conflicts of interest with regard to contracting and other activities. The boards should use the State of Mississippi's conflict of interest statutes, MISS. CODE ANN. Section 25-4-105 and Section 109 of the Mississippi Constitution, as a guide in developing policies.

- The MCC board should discuss with its legal counsel the retainer agreement and obtain an understanding of the average number of hours spent by counsel on providing services to MCC and the purposes of the services. Based on those discussions, MCC should consider discontinuing the \$5,000 per month retainer agreement and paying for legal services by the hour, or some arrangement which incorporates the most economical form of contractual arrangement. MCC should require that counsel provide an itemized billing for services rendered in order to monitor spending for legal services.
3. The MCC and MVCC boards should develop policies for allowable administrative expenses, especially for salaries and fringe benefits. The boards should request input from the Executive Director of the Department of Economic and Community Development for setting salary levels. The boards should set salary levels based on a survey of venture capital company salaries in southern states and on the venture capital experience of the individuals holding the MVCC positions.

Investment Management

4. In keeping with MVCC's statutory purpose of holding state funds only until such time as venture capital investments in Mississippi businesses can be made:
 - MVCC should discontinue its investments in common and preferred stocks and in corporate bonds which have investment ratings below A as designated by Moody's and Standard and Poor's investment rating services.
 - The MCC board and the MVCC board should obtain an understanding of and regularly discuss the types of marketable securities investments held by MVCC and MVCF and any risks involved in holding those securities.
 - The MVCC board should develop a written plan for temporarily investing funds held until the venture capital investments can be made. The plan should ensure that the funds expected to be used for venture capital in the next one to two years are placed in only the most liquid and conservative investments, such as money market securities. The plan should also prohibit margin loan positions on its investments.
5. In conjunction with any changes to its investment policy, MVCC should adjust its operating revenue and expenditure projections, listed in Appendix E, page 53, to reflect projected reductions in revenue resulting from less risky

investments. For example, in the event that MVCC sells its riskier, higher-yielding investments and buys more conservative investments with lower earnings potential, MVCC will realize lower revenues and therefore should reduce its future spending levels in order to continue operations without losses.

Program Compliance With State Law

6. MVCC should cease making investments until the \$4,500,000 private investment requirement is met.
7. The MVCC board should approve future business investment applications using statutory criteria that seventy percent of investments be made in “start-up” businesses to bring its business investment portfolio into compliance with the statutory requirement.

Recommendations: If Mississippi Abolishes the Present Venture Capital Program

If the Legislature chooses to abolish the present venture capital program, the entities involved should take steps to address recouping assets and equity investments, maintaining the program structure until transfer of moneys and duties is accomplished and placement of venture capital duties with state officials is completed. The Legislature should consider various alternative structures when creating a new venture capital program.

Abolition of the Current Program

8. Legislative amendments to abolish the current venture capital program should provide for the systematic liquidation of the subsidiary corporation’s (MVCC’s) assets and equity investments. The Legislature should require the parent corporation, MCC, to merge MVCC duties and assets under its authority and to continue intact until all assets are transferred to the State Treasurer. Assets of the venture capital program should be deposited into the “State Treasury - Venture Capital Fund” and re-appropriated by the Legislature, should it choose to do so.

Creation of a New Program

9. If the Legislature chooses to create a new venture capital vehicle to channel state resources to private businesses, it should consider several alternatives available for such a program. These alternatives include creating a new venture capital incentive for private organizations to administer the program (such as in North Carolina, which at one time provided state tax credits for investors) or shifting the currently allocated resources to existing business loan or equity investment programs.

Recommendations for Recovery and Prosecution

10. The Mississippi Ethics Commission should determine whether conflict of interest violations have occurred and pursue recovery of funds in instances where such payments have been made in violation of the ethics laws.
11. The State Auditor should pursue recovery of venture capital program funds where payments have been made on the basis of false invoices or as a result of fraud.
12. The Attorney General should determine whether officers or employees of MVCC committed fraud or other crimes and prosecute those who committed criminal acts.

**Flow of Funds Associated with the Implementation and Operation of the Venture Capital Program
(Through February 1, 1997)**



Appendix B

Reconciliation of Bond Proceeds \$20,000,000 Taxable State of Mississippi General Obligation Bonds, Series 1994 (Magnolia Venture Capital Project)

Final Disposition of Proceeds

		Magnolia Capital Corporation	Magnolia Venture Capital Corporation	Magnolia Venture Capital Fund	State Treasurer	Bond Issue- Related Vendors
Uses of Bond Proceeds:						
• Legal fees and other bond issuance costs	\$31,494					\$31,494
• Purchase of securities to fund repayment of bond principal	6,176,600				6,176,600	
• Repayment of temporary loans from Department of Economic & Community Development	600,000	5,000	595,000			
• Payment to Magnolia Capital Corporation for purchase of stock in Magnolia Venture Capital Corporation*	13,000,000		5,000,000	8,000,000		
• Balance deposited in Magnolia Capital Corporation	191,906	191,906				
Face Value of Bonds Issued	\$20,000,000	\$196,906	\$5,595,000	\$8,000,000	\$6,176,600	\$31,494

NOTE: * Amount wired directly to MVCC.

SOURCE: MVCC, DECD, Department of Finance and Administration and State Treasury records.

Appendix C

Summary of Cash Transactions of Magnolia Capital Corporation, Magnolia Venture Capital Corporation, and Magnolia Venture Capital Fund, June 1994 to January 1997

		Magnolia Capital Corp. (MCC)	Magnolia Venture Capital Corp. (MVCC)	Magnolia Venture Capital Fund (MVCF)	TOTAL
Jun-94	Received temporary loan from DECD	\$100,000			\$100,000
Jun-94	MCC made capital contribution to MVCC	(95,000)	95,000		
FY1994	Other changes in cash	(473)	(15,260)		(15,733)
FYE 6/30/94	Cash and Marketable Securities at Cost	\$4,527	\$79,740	\$0	\$84,267
Jul-94	Received temporary loan from DECD	\$500,000			\$500,000
Jul-94	MCC made capital contribution to MVCC	(500,000)	500,000		
Sep-94	Received net bond proceeds	13,000,000			13,000,000
Sep-94	MCC made capital contribution to MVCC	(13,000,000)	13,000,000		
FY1995	Other changes in cash	(3,544)	(1,183,139)		(1,186,683)
FYE 6/30/95	Cash and Marketable Securities at Cost	\$983	\$12,396,601	\$0	\$12,397,584
Sep-95	Received final proceeds of bonds	\$191,906			\$191,906
Dec-95	Investment in MVCF by MVCC		(8,000,000)	8,000,000	
Dec-95	Investment by outside limited partner			5,000,000	5,000,000
Apr-96	Limited partner withdrawal of capital			(675,000)	(675,000)
FY1996	Distributions to general partner MVCC and the limited partner		128,162	(206,371)	(78,209)
FY1996	Other changes in cash	(1,414)	(1,522,734)	275,508	(1,248,640)
FYE 6/30/96	Cash and Marketable Securities at Cost	\$191,475	\$3,002,029	\$12,394,137	\$15,587,641
Aug-96	Venture Capital Investment			(\$650,000)	(\$650,000)
Oct. & Nov. 96	Limited partner withdrawal of capital			(4,175,000)	(4,175,000)
7 mos.	Distributions to general partner MVCC and the limited partner		514,595	(693,708)	(179,113)
7 mos.	Other changes in cash	(81,430)	(685,878)	584,924	(182,384)
Jan. 31, 1997	Cash and Marketable Securities at Cost	\$110,045	\$2,830,746	\$7,460,353	\$10,401,144
	Difference in Cost and Market Value of Securities		(33,108)	(36,088)	(69,196)
Jan. 31, 1997	Market Value of Cash and Marketable Securities	\$110,045	\$2,797,638	\$7,424,265	\$10,331,948

SOURCE: PEER staff analysis of Corporation and Partnership records bank statements and financial records.

Appendix D

Investment Service Ratings for Common Stocks Held by Magnolia Venture Capital Fund at December 31, 1996

Common Stock Name	Amount	"Value Line" Investment Rating for Safety
Integrated Device Technology, Inc.	\$40,875	Below Average
Netscape Communications Corp.	113,750	Below Average
VLSI Technology, Inc.	47,750	Below Average
	<u>\$202,375</u>	
Cypress Semiconductor Corp.	14,125	Average
Teradyne Inc.	24,375	Average
	<u>\$38,500</u>	
U.S. Robotics Corp.	72,000	Not Rated
	<u>72,000</u>	
Total	<u><u>\$312,875</u></u>	

NOTE: MVCC sold all of these stocks in January 1997, with the exception of Teradyne, Inc., for a total gain of \$39,461.04.

SOURCES: Magnolia Venture Capital Fund records
The Value Line Investment Survey, January 31, 1997,
Value Line Publishing, Inc., New York, New York

APPENDIX E

MAGNOLIA VENTURE CAPITAL CORP PROJECTION

	FYE 6/30/96 (actual)	1/1- 6/30/97 (6 mo.)	FYE 6/30/98	FYE 6/30/99	FYE 6/30/00	FYE 6/30/01
REVENUE						
Earnings distr fr MVCF:	128,162	314,874	582,120	518,616	455,112	455,112
Earnings fr MVCC funds:	653,435	150,000	153,449	166,187	174,794	179,020
Sale of excess f&e		10,000				
Total revenue	781,597	474,874	735,569	684,803	629,906	634,132
EXPENSES						
Salaries & wages	928,032	141,800	283,600	297,780	312,669	328,302
TB'sfinal payment		117,983				
Payroll taxes	38,510	12,542	13,850	14,543	15,270	16,033
Employee insurance	53,758	8,000	16,000	17,600	19,360	21,296
Retirement plan	32,788	7,092	14,184	14,893	15,638	16,420
Contract services	41,855	2,500	5,000	5,000	5,000	5,000
Automotive & parking	17,180	5,760	11,520	12,096	12,701	13,336
Repairs & maintenance	1,671	2,500	5,000	5,000	3,000	3,000
Public relations	5,752	1,000	2,000	2,100	2,205	2,315
Rent expense	39,878	8,040	14,400	14,400	14,400	14,400
Telephone	23,890	3,600	7,200	7,560	7,938	8,335
Equipment rental	4,090	2,030	1,800	1,000	1,050	1,103
Liab/prop insurance	58,152	28,500	57,000	57,000	57,000	57,000
Legal fees	109,830	50,000	36,000	37,800	39,690	41,675
Accounting/audit fees	9,531	1,200	6,000	6,300	6,615	6,946
Office supplies & postage	8,744	1,200	2,400	2,520	2,646	2,778
Management fees	586,432					
Travel & meals	55,800	9,000	18,000	15,000	12,000	10,000
Board meetings	11,525					
Dues & subscriptions	25,615	1,800	3,600	3,780	3,969	4,167
Prof education/seminars	5,265	2,250	4,500	4,725	4,961	5,209
Library/research matis	506	600	1,200	1,260	1,323	1,389
Equipment purchases						
Officer life insurance	7,161					
Other expenses	7,283	10,000	20,000	21,000	22,050	23,153
Total expenses	2,073,248	417,397	523,254	541,357	559,485	581,857
NET PROFIT (LOSS)	(1,291,651)	57,477	212,315	143,447	70,422	52,275
Total funds at beginning		2,500,000	2,557,477	2,769,792	2,913,238	2,983,660
Total funds at end		2,557,477	2,769,792	2,913,238	2,983,660	3,035,935

SOURCE: MVCC.

APPENDIX E (Continued)

MAGNOLIA VENTURE CAPITAL FUND

PROJECTION

	Beginning Balance	VC Equity Investmt (1/2)	Ending Balance	Annualized Yield	Interest Earnings	FY Income	MVCC Share (98%)
Mar. 97	7,500,000	360,000	7,140,000	9%	160,650		
Jun. 97	7,140,000		7,140,000	9%	160,650	321,300	314,874
Sep. 97	7,140,000	360,000	6,780,000	9%	152,550		
Dec. 97	6,780,000		6,780,000	9%	152,550		
Mar. 98	6,780,000	360,000	6,420,000	9%	144,450		
Jun. 98	6,420,000		6,420,000	9%	144,450	594,000	582,120
Sep. 98	6,420,000	360,000	6,060,000	9%	136,350		
Dec. 98	6,060,000		6,060,000	9%	136,350		
Mar. 99	6,060,000	360,000	5,700,000	9%	128,250		
Jun. 99	5,700,000		5,700,000	9%	128,250	529,200	518,616
Sep. 99	5,700,000	360,000	5,340,000	9%	120,150		
Dec. 99	5,340,000		5,340,000	9%	120,150		
Mar. 00	5,340,000	360,000	4,980,000	9%	112,050		
Jun. 00	4,980,000		4,980,000	9%	112,050	464,400	455,112

ASSUMPTION: One half of all VC investments will be in the form of convertible loans (with warrants), and the other half will be pure equity deals. The loans will have a market interest rate requiring interest-only payments until called. Our goal is to invest \$360,000 per calendar quarter.

SOURCE: MVCC.

Agency Responses



**MAGNOLIA VENTURE
CAPITAL CORPORATION**

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601.352.5201 • 800.249.6360
FAX 601.355.1804

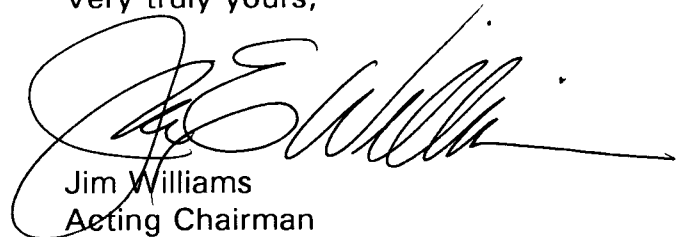
March 6, 1997

Hon. Billy Bowles
Chairman
PEER Committee
P. O. Box 1204
Jackson, MS 39215-1204

Dear Mr. Bowles:

The Board of Directors of Magnolia Venture Capital Corporation is prepared to take whatever action necessary to continue the venture capital program consistent with legislative intent, or to take such steps as necessary to liquidate the corporation if that is deemed appropriate.

Very truly yours,



Jim Williams
Acting Chairman



MAGNOLIA CAPITAL CORPORATION

March 7, 1997

Legislative PEER Committee
222 N. President Street
Jackson, Mississippi 39201

Attention: Mr. Sam Dawkins



REF: Venture Capital Act of 1994

Dear Sir:

On March 6th, 1997 PEER Committee Staff allowed myself and the attorney for Magnolia Capital Corporation (MCC) to review the Committee's Review of the Venture Capital Act of 1994 and the Operations of the Magnolia Venture Capital Corporation dated March 5, 1997.

The purpose of this letter is to provide the PEER Committee with our written responses to the findings and recommendations as to the future of a Capital Venture Corporation for the State of Mississippi.

There is absolutely no question, that the Venture Capital Act of 1994 was established as being in the best interest of the business community and the general welfare of the citizens of the State of Mississippi. IT WAS THEN AND IS NOW A GOOD PROGRAM.

In the PEER Committee's Report, the Committee stated that MCC efforts to audit the MVCC operation was at fault due to the fact that MVCC did not furnish the data requested by State Statute, and that MCC should have taken a possible legal action by way of a writ of mandamus in obtaining such information as needed.

As a matter of fact, the Board of MCC discussed this same matter with legal counsel on numerous occasions, and we were given several options.

- 1.) Seek the information through a mandamus action; or
- 2.) Ask the PEER Committee for assistance to avoid unnecessary publicity,

As a result of having considered these options carefully, it was the decision of MCC to avoid the court action if at all possible, and proceed with obtaining the requested information from MVCC with the assistance of the PEER Committee. Chairman Dudley Guice on or about June 1996 requested assistance from the PEER Committee.

This action by MCC was beneficial in that without the assistance of all agencies which afterward got involved in this matter; that full disclosure of MVCC would not have been possible. MCC Board and it's officers and directors thank the PEER Committee and the State Attorney General's Staff for a job well done.

MCC since having taken this course of action, finds that MVCC has attempted to make certain changes in it staff and operation in order to comply with the purpose and intent of the Venture Capital Act, one of which was to remove Chairman Steve Caldwell and to cut the operation costs.

The PEER Committee's recommendations that the Legislature should amend Section 57-77-21 of the Mississippi Code to require that MVCC furnish MCC with a compiled monthly and/or quarterly financial statement (detailing all revenue and expense) and the same be furnished to all of the members of the Board of Directors of MCC, the Executive Director of DECD and the State Auditor is a good proposal and we concur 100% percent.

Without hesitation, the Legislature should immediately adopt as a vital part of the MVC Act of 1994 provisions of Section 25-4-105 Mississippi Code and Section 109 Mississippi Constitution in reference to conflict of interest. It is clear that certain parties should be prohibited from doing business with either MCC or MVCC, including parties related, business owned by employees, staff, and or board members. At no time should there appear to be any question of impropriety. MCC encourage such legislation.

In addition, MCC finds that the Legislature should make provisions in the act for a criminal prosecution for anyone found to be in violations of the Act, which would include a heavy fine and incarceration in the State penitentiary.

To dissolve the existing Venture Capital Act would be a step backward to the past. MCC would like to go on record stating that the best interest to the business community and the citizens of the State of Mississippi would be to correct any existing problem, and to proceed forward performing and accomplishing the intent and purposes of the Act.

Sincerely,


DUDLEY GUICE-CHAIRMAN MCC

**RESPONSE OF THE DEPARTMENT OF ECONOMIC
AND COMMUNITY DEVELOPMENT TO DRAFT PEER REPORT
ON MAGNOLIA VENTURE CAPITAL ACT**

The Department of Economic and Community Development (DECD) would state that venture capital is needed in Mississippi. DECD would welcome the opportunity to work with the legislature to determine the best way to continue a venture capital program in Mississippi, whether it is by amending the present act or by abolishing the act and starting over with new legislation. Further, as long as the present venture capital program continues, DECD will explicitly follow the recommendations expressed by PEER and those gleaned from the PEER findings, requiring both detailed and timely annual audits and reports as to the information required in the statute and the loan agreement.

Before responding to the findings, DECD must point out that notice of this draft was only received by DECD at 9:45 a.m., March 6, 1997, with any response being due by DECD by 5:00 p.m., March 7, 1997. DECD did not have time to fully study the draft and prepare a comprehensive response to the findings.

DECD will now respond to those findings which mention or implicate DECD and with which DECD disagrees or thinks further explanation is warranted. Such findings will be restated by DECD and the response will follow.

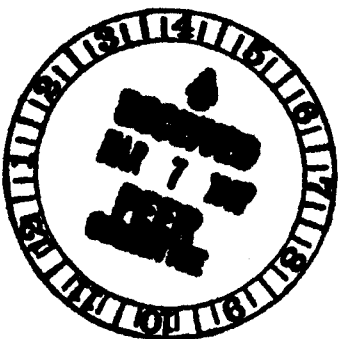
PEER FINDING: Neither the MVCC board, the MCC board, nor DECD have exercised substantive and periodic oversight over MVCC operations, expenses or performance, which has resulted in weakness in the administration of the Venture Capital Act.

DECD RESPONSE: DECD denies that it failed to exercise substantive and periodic oversight over MVCC operations.

PEER FINDING: DECD exercised no ongoing oversight of Venture Capital Act operations and committed noncompliance with statutory reporting requirements even though this was a material default and a covenant of its loan agreement.

DECD RESPONSE: DECD denies generally the above finding. DECD specifically denies that reporting information required in the statute and in the loan agreement was not provided two consecutive years. DECD affirmatively states that information was received by way of audit reports and/or balance sheets within five months of each year end in each of the last three fiscal years.

DECD affirmatively states that it did exercise its oversight



responsibility in that upon learning of possible problems with Magnolia Venture Capital Corporation, DECD contacted the State Auditor's Office with its concerns. This appears to DECD to be the proper oversight response and to find that DECD did not exercise any oversight responsibility is unfair and untrue.

As to annual audits and annual reports, in November 1994, DECD received a document entitled "Balance Sheet With Independent Auditor's Report thereon, of Magnolia Venture Capital Corporation (a wholly owned subsidiary of Magnolia Capital Corporation) as of September 30, 1994." In DECD's view this document served as both the annual audit and annual report. Information contained in this document materially met the requirements of the annual report as required by statute and the loan agreement. DECD further knew that MVCC had not raised the required \$4.5 million as of September 30, 1994, and that no Venture Capital assistance had been provided as of September 30, 1994.

In November of 1995, DECD received a document entitled "Balance Sheet of Magnolia Venture Capital Corporation (a wholly owned subsidiary of Magnolia Capital Corporation) (with independent auditors report thereon) as of June 30, 1995. In DECD's view this document served as both the annual audit and annual report. Information contained in the document materially met the requirements of the annual report, including office lease expenses. DECD also knew that MVCC had not raised the required \$4.5 million as of June 30, 1995, and that no Venture Capital assistance was provided as of June 30, 1995.

On November 21, 1996, DECD received documents entitled "Financial Statements of Magnolia Venture Capital Fund Limited Partnership (with independent auditors report thereon) as of June 30, 1996" and "Financial Statement of Magnolia Venture Capital Corporation (with independent audits report thereon) as of June 30, 1996." In DECD's view these documents served as both annual audit and annual report. The documents contained information concerning office expenses and other administrative information. The documents also contained confirmation that the required \$4.5 million in private investments had been raised and that no venture capital assistance had been provided since June 30, 1996. The report acknowledges that a venture

capital assistance had occurred in August of 1996, which was after the fiscal year end. Therefore DECD denies this finding.

Since the required information relative to the annual report was received and known by DECD in each of the fiscal years in question, it was not and it is not now the opinion of DECD that MCC was in default under the terms of loan agreement. Therefore there was no basis for the leverage suggested in PEER's finding.

While DECD has shown that it received or knew of the required information, DECD acknowledges that the technical requirements of the statute were perhaps not followed, in that a separate annual report was not demanded and will therefore follow the suggestions of PEER, both express and implied, in its future oversight of the venture capital program.

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